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No.

In the Supreme Court of the United States

October Term, 1986

ROTH STEEL TUBE COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

BENNET KLEINMAN*
ROBERT L. MERRITT
FREDERICK N. WIDEN
KAHN, KLEINMAN, YANOWITZ & ARNSON CO., L.P.A.
1300 Bond Court Building
Cleveland, Ohio 44114
(216) 696-3311
Counsel for Petitioner

**Counsel of Record*

THE GATES LEGAL PUBLISHING CO., CLEVELAND, OHIO—TEL. (216) 621-5647

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QUESTIONS PRESENTED

1. Did the Court of Appeals for the Sixth Circuit err in holding that, upon an appeal from a decision of the United States Tax Court characterizing advances to a corporation as debt or equity, the standard of review to be applied is to treat the issue as a question of fact subject to review pursuant to the clearly erroneous rule, rather than as primarily a question of law subject to *de novo* review?

2. Did the Court of Appeals for the Sixth Circuit err in holding that under circumstances such as are present in this case, a Court of Appeals need not hear and decide, or remand to the United States Tax Court, an Internal Revenue Code §165(g)(3) issue first raised on appeal?

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PETITION FOR WRIT OF CERTIORARI

OPINIONS BELOW

The Opinion of the Court of Appeals for the Sixth Circuit below is reported at 800 F.2d 625 (1986), and is set forth in Appendix A. The Opinion of the United States Tax Court, T.C. Memorandum Opinion 1985-58, is set forth in Appendix B, and the Order of the United States Tax Court of May 21, 1985 is set forth in Appendix C. The Memorandum Sur Order of the United States Tax Court of May 21, 1985 is set forth in Appendix D.

STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals for the Sixth Circuit in this case (set forth in Appendix E) was entered on September 10, 1986. A petition for rehearing *en banc* was filed on September 24, 1986. An

Order of the Court of Appeals (set forth in Appendix F) denying the Petitioner's petition for rehearing *en banc* was entered on October 22, 1986. The mandate of the Court of Appeals was issued on October 30, 1986 (See Appendix E). This Court has jurisdiction to review the judgment of the United States Court of Appeals for the Sixth Circuit under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS INVOLVED

26 U.S.C. (hereinafter sometimes "I.R.C.") §165(a), (b), (f) and (g), §166(a) and (b), and §7482(a) and (c):

SEC. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

* * * * *

(f) *Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) *Worthless Securities.*—

(1) *General Rule.*—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or

exchange, on the last day of the taxable year, of a capital asset.

(2) *Security Defined.*—For purposes of this subsection, the term "security" means--

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) *Securities in Affiliated Corporation.*—For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) stock possessing at least 80 percent of the voting power of all classes of its stock and at least 80 percent of each class of its nonvoting stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom. As used in subparagraph (A), the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

* * * * *

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly Worthless Debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * * * *

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

* * * * *

SEC. 7482. COURTS OF REVIEW.

(a) *Jurisdiction.*—The United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit) shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the

Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code.

* * * * *

(c) *Powers.*—

(1) *To Affirm, Modify, or Reverse.*—Upon such review, such courts shall have power to affirm or, if the decision of the Tax Court is not in accordance with law, to modify or to reverse the decision of the Tax Court, with or without remanding the case for a rehearing, as justice may require.

STATEMENT OF THE CASE

Roth Steel Tube Company (hereinafter "Roth Steel") is an Ohio corporation whose principal business activity during the years at issue was the manufacturing of steel tubing. In August 1972 Roth Steel purchased 62% of the issued and outstanding shares of common stock (the only class of capital stock issued and outstanding) of Remco Industries, Inc., a New Jersey corporation (hereinafter "Remco"), which manufactured children's toys.

The acquisition by Roth Steel of 62% of the issued and outstanding shares of common stock of Remco entitled Roth Steel under New Jersey law and Remco's certificate of incorporation to elect the entire board of directors of Remco, there being no cumulative voting. At all times here pertinent Remco stock was traded on the Over-The-Counter Market, and the 38% of the outstanding shares of common stock of Remco not owned by Roth Steel was owned by the investing public.

After the acquisition of control of Remco by Roth Steel, it developed that Remco needed short-term working

capital for its day-to-day operations (not for the acquisition of capital assets) in addition to the working capital advanced to it by unrelated lenders. Roth Steel made substantial advances to Remco for such working capital needs during the period November 1972 through October 1973. No advances were made to Remco by any stockholder of Remco other than Roth Steel. Such advances were characterized as debt in resolutions of Remco's board of directors; both Roth Steel and Remco treated the advances as loans on their accounting records; Remco contemporaneously acknowledged to Roth Steel's independent certified public accountants, in connection with their audit of Roth Steel, that it was indebted to Roth Steel on account of Roth Steel's advances to it, and reflected accrued interest expense on the Roth Steel advances on its accounting records; Roth Steel accrued interest from its advances to Remco on its general ledger as "Interest Income - Remco" and "Interest Receivable - Remco," and reported interest income from Remco on its Forms 1120, U.S. Corporation income tax returns for its taxable years ending April 30, 1973 and April 30, 1974.

Due to a lower volume of net sales than anticipated and a sharp increase in 1973 from 19¢ a pound to 65¢ a pound in the cost of styrene and polyethylene used in the toys manufactured by Remco, Remco incurred substantial losses in 1973. Remco discontinued operations in January 1974 because of a lack of working capital for the succeeding toy season, and its assets were turned over to James Talcott, Inc., a commercial factor that had a security interest in Remco's accounts receivable, inventory, and other assets. Roth Steel did not recover any part of its stock investment in Remco, or the balance of its advances to Remco not previously repaid by Remco.

On its federal income tax return for the taxable year ending April 30, 1974, Roth Steel claimed a deduction in

the amount of $553,062 as an ordinary loss on its investment in Remco stock and a bad debt deduction of $2,873,814 on account of unrepaid advances to Remco. The Commissioner of Internal Revenue (hereinafter the "Commissioner"), upon audit, determined that the losses and bad debts claimed by Roth Steel were capital losses, deductible only to the extent of capital gains. In making this determination, the Commissioner treated Roth Steel's advances to Remco as capital contributions rather than loans to Remco, and did not accept Roth Steel's assertion that it had a reasonable expectation of repayment of the advances at the time they were made. Since Roth Steel had no capital gains in its taxable year ending April 30, 1974, the Commissioner did not allow the deductions claimed by Roth Steel.

Roth Steel argued unsuccessfully in the Tax Court that its advances to Remco were capital contributions and not loans. On appeal, the Sixth Circuit held that the question of whether advances were capital contributions or loans is a question of fact, and that it, as a reviewing court, cannot set aside such a factual finding of the Tax Court unless it is clearly erroneous. The Sixth Circuit rejected Roth Steel's contention that the applicable standard of review on the question of capital contributions versus loans is primarily one of law. Although the Sixth Circuit recognized in its Opinion (800 F.2d at 629) that "Courts have . . . taken opposing views on whether the question of capital contributions versus loans is a question of law or fact . . . (citing conflicting decisions of Circuit Courts of Appeals)," it followed its holding in *Smith v. Commissioner*, 370 F.2d 178, 180 (6th Cir. 1966), and held that "we must review the Tax Court's determination that taxpayer's advances to its subsidiary corporation were capital contributions and not loans under the clearly er-

roneous standard." 800 F.2d at 629. Applying the clearly erroneous standard, the Sixth Circuit affirmed the Tax Court's decision that Roth Steel's advances to Remco were capital contributions and not loans.

Since it rejected *de novo* review of the question of law as to whether Roth Steel's advances to Remco were true loans rather than contributions to capital, the Sixth Circuit did not give sufficient consideration to expressions of other Circuit Courts of Appeals which favor, as a matter of law, a determination that the advances made by Roth Steel were indeed true loans.[1]

Roth Steel contended in the Tax Court that it suffered an ordinary loss on its stock investment in Remco based on the *Corn Products* doctrine (350 U.S. 46 (1955)). It did not prevail in this argument, and on appeal to the Sixth Circuit argued for the first time that the entire loss sustained by Roth Steel in its taxable year ending

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1. Although various factors must be considered in determining a debt-equity question, not all are given equal weight, and where more than one heavily weighted factor is present, as a matter of law this should be persuasive. For example, in *Estate of Mixon v. United States,* 464 F.2d 394, 409 (5th Cir. 1972), the Fifth Circuit stated:

> ". . . If advances are made by stockholders in proportion to their respective stock ownership, an equity capital contribution is indicated . . . . A *sharply disproportionate ratio* between a stockholder's percentage interest in stock and debt is, however, *strongly indicative that the debt is bona fide.* . . . (citing cases) . . . Such payments bearing absolutely no relation to the shareholders' pro rata ownership *clearly* are *completely inconsistent* with characterization of the advance as a capital contribution." (Emphasis added)

See also *Estate of Mixon v. United States, supra,* at 410; *Earle v. W. J. Jones & Son,* 200 F.2d 846, 850 (9th Cir. 1952). Further, in *Plantation Patterns, Incorporated v. Commissioner,* 462 F.2d 712, 722 (5th Cir. 1972), *cert. den.* 409 U.S. 1076 (1972), the Fifth Circuit stated that "*Of critical importance* in determining whether financial input is debt or equity is whether or not the money is expended for capital assets." (Emphasis added)

April 30, 1974, on account of its purchase and ownership of stock in Remco (including losses on account of any advances which may be deemed to have been contributions to the capital of Remco) are deductible as ordinary losses under I.R.C. §165(g)(3).

I.R.C. §165(g)(3), as amended by Public Law 91-687, 91st Cong. 2d Sess. (January 12, 1971), provides that the loss resulting to a domestic corporation (the "taxpayer") from stock which becomes worthless during the taxable year shall be treated as an ordinary loss if the corporation whose stock becomes worthless is a corporation affiliated with the taxpayer. A corporation is treated as affiliated with the taxpayer if "(A) stock possessing at least 80 percent of the voting *power* [not "number of shares"] of all classes of its stock and at least 80 percent of each *class* [here the reference is to numbers, not power] of its nonvoting stock is owned directly by the taxpayer." (Emphasis and bracketed words added). I.R.C. §165(g)(3)(B) also requires that the gross receipts test (see *infra* page 17, footnote 6) be met by the corporation whose stock becomes worthless.

Briefly, Roth Steel argued in the Court of Appeals for the Sixth Circuit that the extent of the voting power of stock held by a stockholder is determined by the extent to which the stockholder, on account of his stockholdings, can affect or determine the election of a director or directors of the corporation. See *Commissioner v. Shillito Realty Co.*, 39 F.2d 830, 832 (6th Cir. 1930), *aff'g*, 8 B.T.A. 665 (1927). "Voting power" and "voting stock" do not have the same meaning. Voting stock can have a *vote* without its vote having the *power* to affect the outcome of an election of directors. Where, as here, there was no cumulative voting and where Roth Steel, *acting*

alone, had the power to elect the entire board of directors of Remco, the minority shareholders had the *right to vote* for, but *did not have any power* to, elect directors.

Roth Steel, at all times here pertinent, through its ownership of 62% of the outstanding shares of common stock of Remco had the *voting power,* acting alone, to elect *all* of the directors of Remco. No other shareholder or shareholders, singly or in combination, could through his or their votes determine the election of *any* director of Remco. Thus, Roth Steel held stock possessing 100% of the voting power of Remco common stock, the only class of capital stock of Remco issued and outstanding.[2]

The decision of the Sixth Circuit holding that the worthless securities issue (I.R.C. §165(g)(3)), not having been raised below, should not be considered on appeal or remanded, fails to address, and is directly contrary to, the holdings of the Court of Appeals for the Fourth Circuit in *Road Materials, Inc. v. Commissioner,* 407 F.2d 1121 (4th Cir. 1969), and of the Court of Appeals for the Fifth Circuit in *Inness v. Commissioner,* 413 F.2d 290 (5th Cir. 1969), where in both cases the Courts of Appeals remanded a Section 165(g)(3) issue to the Tax Court under circumstances identical to those present here.

This petition for a writ of certiorari requests that the Section 165(g)(3) issue be decided by this Court, or remanded to the Sixth Circuit for decision or for remand to the Tax Court.

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2. In connection with Roth Steel's contention that its ownership of approximately *62% of the voting stock* of Remco constituted *100% of the voting power,* attention is called to *Trotz v. Commissioner,* 361 F.2d 927 (10th Cir. 1966), where *ownership of 79% of the outstanding stock* of a corporation was *held to constitute more than 80% in value of the outstanding stock* of the corporation. To the same effect, see *United States v. Parker,* 376 F.2d 402 (5th Cir. 1967); *Childers v. United States,* 542 F.2d 1243 (4th Cir. 1976).

REASONS FOR ALLOWING THE WRIT

The decision of the Court of Appeals that the characterization of the advances made by Roth Steel to Remco as debt or equity is a question of fact subject to clearly erroneous review, and is not one of law subject to *de novo* review by the Court of Appeals, cannot be reconciled with decisions of this Court and is in direct conflict with and contrary to decisions of the Third, Fifth, Seventh, Eighth and Eleventh Circuit Courts of Appeals. The Sixth Circuit's opinion (800 F.2d at 629, Appendix A at A9), specifically states that appellate courts have "taken opposing views on whether the question of capital contributions versus loans is a question of law or fact". The Sixth Circuit chose to follow its own previous holding, and a holding of the Ninth Circuit, that the question is one of fact. The failure to follow this Court's characterization of the question as a question of law, and the conflict among Circuit Courts of Appeals on this issue, creates a need for definitive resolution by this Court of the standards of review which should apply in this and future cases when resolving a debt-equity characterization issue on appeal.

Further, the refusal by the Court of Appeals to hear or remand the worthless securities issue under Section 165(g)(3) of the Internal Revenue Code,[3] raised by Roth Steel for the first time on appeal, is directly contrary to the decisions of the Fourth and Fifth Circuit Courts of Appeals involving the precise statutory section (but different legal issues under that section). Justice requires that appellants not be subjected to different rules in dif-

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3. Unless otherwise specified, all section references herein are to the Internal Revenue Code of 1954 as amended and in effect for the taxable years at issue.

ferent Courts of Appeals as to what legal issues will be heard on appeal and under what circumstances, and there is a need for a governing rule to be articulated by this Court.

I. THE DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS ON THE APPLICABLE STANDARD OF REVIEW CANNOT BE RECONCILED WITH DECISIONS OF THIS COURT AND DIRECTLY CONFLICTS WITH DECISIONS OF THE COURTS OF APPEALS FOR THE THIRD, FIFTH, SEVENTH, EIGHTH AND ELEVENTH CIRCUITS

The issue of whether advances made to a corporation gives rise to indebtedness and are not contributions to capital has been recognized by this Court to be a question of law. Thus, in *John Kelley Company v. Commissioner of Internal Revenue*, 326 U.S. 521, 529 (1946), when determining whether payments made by a corporation to holders of its debenture obligations were deductible interest payments or non-deductible dividend payments, this Court stated that "in the present cases, it might be said to be a question of law was to whether the primary facts adduced made the payments under consideration dividends or interest." Nevertheless, following the rule of *Dobson v. Commissioner of Internal Revenue*, 320 U.S. 489 (1943), that upon judicial review of decisions of the Board of Tax Appeals (now the United States Tax Court) appellate courts are to leave to the final determination of the Board (Tax Court) all issues which are not clear-cut questions of law, this Court held in *Kelley* that the Tax Court's determination was not subject to appellate review. However, the *Dobson* rule was repealed in 1948 by amendment of 26 U.S.C. §1141(a) (now 26 U.S.C. §7482). Thereafter, the Eighth

Circuit, in *J. S. Biritz Construction Co. v. Commissioner of Internal Revenue*, 387 F.2d 451, 455 (8th Cir. 1967), after reciting this Court's decisions in *Dobson* and *Kelley* and their subsequent statutory repeal, interpreted such repeal to now require that the issue of debt versus equity not be treated "solely or even essentially a factual one but [as] a mixed question of law and fact." See also the concurring opinion of Circuit Judge Waterman in *Gilbert v. Commissioner of Internal Revenue*, 248 F.2d 399, 408-9 (2nd Cir. 1957). The Sixth Circuit decision below is in conflict with the foregoing decisions, and is also in conflict with decisions of the Courts of Appeals for the Fifth Circuit (*Estate of Mixon v. United States*, 464 F.2d 394, 402-3 (5th Cir. 1972)), the Seventh Circuit (*Ortmayer v. Commissioner of Internal Revenue*, 265 F.2d 848, 854 (7th Cir. 1959)), and the Eleventh Circuit (*Slappey Drive Industrial Park v. United States*, 561 F.2d 572 (5th Cir. 1977); *In re Lane v. United States*, 742 F.2d 1311 (11th Cir. 1984)), all of which held that the applicable standard of review in a debt versus equity case is a review *de novo* as primarily a question of law. See also *Scriptomatic, Inc. v. United States*, 555 F.2d 364, 372 footnote 13 (3rd Cir. 1977) ("The ultimate issue, whether an instrument constitutes debt or equity, is a matter of law, and, as such, is to be decided by the trial court [and not by the jury].")

As pointed out by Circuit Judge McCree in the Court's opinion in *Austin Village, Inc. v. United States*, 432 F.2d 741, 744 (6th Cir. 1970), the determination of whether advances by shareholders represent debt or equity involves the process of attaching a legal characterization to historical events found to have occurred, "and, as such, the determination is a question of law. It requires the application of certain established criteria to a set of facts

in order to attach a legal characterization and consequences to those facts . . . ." This analysis, which the Sixth Circuit did not follow in the proceeding below, is in accord with the conclusion of this Court in *Helvering v. Tex-Penn Oil Co.*, 300 U.S. 481, 491 (1937), that "The ultimate finding (of the Board of Tax Appeals, now the Tax Court) is a conclusion of law or at least a determination of a mixed question of law and fact. It is to be distinguished from the findings of primary, evidentiary, or circumstantial facts. It is subject to judicial review and, on such review, the court may substitute its judgment for that of the Board. *Helvering v. Rankin, ubi supra* [295 U.S. 123, 55 S. Ct. 732, 79 L. Ed. 1343]." See *Thornley v. Commissioner of Internal Revenue*, 147 F.2d 416, 420 (3rd Cir. 1945); *Ortmayer v. Commissioner of Internal Revenue*, 265 F.2d 848, 854 (7th Cir. 1959); *Galena Oaks Corporation v. Scofield*, 218 F.2d 217, 219-20 (5th Cir. 1954); *Commissioner of Internal Revenue v. Meridian & Thirteenth Realty Co.*, 132 F.2d 182, 188 (7th Cir. 1942).

The Sixth Circuit in this case, rejected the foregoing decisions and followed its own prior decision in *Smith v. Commissioner*, 370 F.2d 178 (6th Cir. 1966), and the decision of the Ninth Circuit in *Bauer v. Commissioner*, 748 F.2d 1365 (9th Cir. 1984)[4] (which in turn followed *A. R. Lantz Co., Inc. v. United States*, 424 F.2d 1330 (9th Cir. 1976)), that the applicable standard of review in a debt-equity controversy precludes overturning a trial court's decision unless it is clearly erroneous because the

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4. The Ninth Circuit, in *Bauer*, erroneously refers to Treasury Regulations being extant since 1982 setting forth factors to be considered in determining whether an advance is debt or equity under 26 U.S.C. §385, enacted in 1969. The Court apparently was unaware that the Regulations had been withdrawn by T.D. 7920, 1983-2 C.B. 69, effective August 5, 1983 (and continue to be withdrawn without replacement).

issue is a factual issue. This conflict between the Sixth and Ninth Circuit Court of Appeals and the decisions of other Circuit Courts of Appeals can only be resolved by a decision of this Court which makes clear that as a result of the statutory repeal of the *Dobson* rule, the applicable standard of review in debt versus equity cases is a review *de novo* of primarily a question of law.

The Commissioner of Internal Revenue has argued unsuccessfully in the Sixth Circuit in *Austin Village, Inc. v. United States*, 432 F.2d 741 (6th Cir. 1970), and in *Ragland Investment Company v. Commissioner of Internal Revenue*, 435 F.2d 118 (6th Cir. 1970), that whether a security represents debt or equity for tax purposes is a question of law and not a question of fact, and that the clearly erroneous standard of review does not apply. However, in other cases, such as *J. S. Biritz Construction Co. v. Commissioner of Internal Revenue, supra* page 13, the Commissioner has argued unsuccessfully that the debt versus equity determination by the Tax Court involves an issue of fact requiring application of the clearly erroneous standard. These conflicting decisions, including the 1984 decision of the Eleventh Circuit in *Re Lane* (742 F.2d at 1315) (the issue is primarily one of law), the 1984 decision of the Ninth Circuit in *Bauer* (748 F.2d at 1367) (the issue is one of fact), and the 1986 decision of the Sixth Circuit in the instant case (the issue is one of fact), can only be resolved by this Court.

II. THE DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS IN REFUSING TO HEAR OR REMAND THE WORTHLESS SECURITIES ISSUE DIRECTLY CONFLICTS WITH DECISIONS OF THE COURTS OF APPEALS FOR THE FOURTH AND FIFTH CIRCUITS

The Decision of the Sixth Circuit holding that the worthless securities issue (I.R.C. §165(g)(3)), not having been raised in the Tax Court, should not be considered on appeal or remanded, fails to address, and is directly contrary to, the holdings of the Court of Appeals for the Fourth Circuit in *Road Materials, Inc. v. Commissioner*, 407 F.2d 1121, 1125-26 (4th Cir. 1969), and of the Court of Appeals for the Fifth Circuit in *Inness v. Commissioner*, 413 F.2d 290 (5th Cir. 1969), where in both cases the Courts of Appeals remanded a Section 165(g)(3) issue to the Tax Court under circumstances identical to those present here. In the interests of justice the applicable rule should be uniform in all Circuits, for otherwise the outcome of litigation will depend upon where a case is heard on appeal and not on a rule of law or procedure uniformly applied by all Circuit Courts of Appeals.

In *Road Materials*, the Fourth Circuit upheld a decision of the Tax Court that certain advances to a corporation were not loans and therefore not deductible as bad debts under I.R.C. §166(a)(1). However, the Fourth Circuit remanded the case to the Tax Court,[5] stating (407 F.2d at 1125-1126):

> "The taxpayer claims in this cost *for the first time* that if the $497,265.83 is not deductible as a bad debt,

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5. On remand the issue was submitted for decision on the record already before the Tax Court with certain additional stipulated documents, and the Tax Court made fresh findings. *See Road Materials, Inc.*, T.C. Memo. 1971-170, 30 TCM 728, 729 (1971).

it should be considered an ordinary loss because the investment was in securities of an affiliated corporation within the meaning of Int. Rev. Code of 1954 §165(g)(3) [26 U.S.C. §165(g)(3) (1967)]. This issue raises factual and legal questions that should be considered in the first instance by the Tax Court, and to that end we remand." (Emphasis added)

See also I.R.C. §7482(c)(1) (a Court of Appeals may modify or reverse a decision of the Tax Court "with or without remanding the case for a rehearing, as justice may require."); *Wilson v. Commissioner*, 500 F.2d 645, 649 (2nd Cir. 1974) (allowing a taxpayer to raise a new issue for the first time on appeal in the "interests of justice," following and quoting from *Hormel v. Helvering*, 312 U.S. 552, 556-7 (1941)); *Ah Pah Redwood Co. v. Commissioner*, 251 F.2d 163, 168-9 (9th Cir. 1957) (a new issue can be raised on appeal "to prevent a miscarriage of justice"); *Legg's Estate v. Commissioner*, 114 F.2d 760, 767 (4th Cir. 1940) ("there is a well-established rule that an appellate court has the power, without determining or disposing of a case, to remand it to the lower court for further proceedings if the case has been tried on a wrong theory, or the record is not in condition for the appellate court to decide the question presented with justice to all parties concerned. . . . (citing numerous cases).")

We submit that Roth Steel's contention that Section 165(g)(3) applies to the substantial loss suffered by it from its advances to Remco, should be addressed and decided by this Court or should be remanded for decision.[6]

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6. The only factual issue, if any, were the Section 165(g)(3) issue to be remanded to the Tax Court, would be whether "(B) more than 90 percent of the aggregate of [Remco's] gross receipts for all taxable years has been from sources other than royalties.

(Continued on following page)

III. REVIEW OF THE DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS IS NEEDED TO PROMOTE UNIFORM RULES AND STANDARDS OF REVIEW ON APPEAL FROM DECISIONS OF THE UNITED STATES TAX COURT TO CIRCUIT COURTS OF APPEALS

The decision of the Sixth Circuit on the standard of review issue is not reconcilable with decisions of this Court, and directly conflicts with the majority of the Circuit Courts of Appeals which have passed upon the issue. Further, the decision of the Sixth Circuit on whether a Section 165(g)(3) issue first raised on appeal can be heard or remanded to the Tax Court, is directly contrary to the decisions of the only two Circuit Courts of Appeals which have passed upon that specific question. The resolution of these conflicts and the establishment of guidelines for future cases, can be accomplished by this Court hearing and deciding this case.

Footnote continued—

rents . . ., dividends, interest . . ., annuities, and gains from sales or exchanges of stock and securities." While the Tax Court made no specific finding that Remco met the 90% gross receipts test of I.R.C. §165(g)(3), Remco clearly did, and the Record in the Tax Court below with respect to gross receipts of Remco shifts the burden of proof to the contrary to the Commissioner of Internal Revenue.

CONCLUSION

For the reasons set forth above, this petition for a writ of certiorari should be granted.

Respectfully submitted,

BENNET KLEINMAN*
ROBERT L. MERRITT
FREDERICK N. WIDEN
KAHN, KLEINMAN, YANOWITZ &
ARNSON CO., L.P.A.
1300 Bond Court Building
Cleveland, Ohio 44114
(216) 696-3311
Counsel for Petitioner

**Counsel of Record*

APPENDIX A

Opinion of the United States Court of Appeals For the Sixth Circuit

(Filed September 10, 1986)

No. 85-1656

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

ROTH STEEL TUBE COMPANY,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

ON APPEAL from the United States Tax Court.

Before: MILBURN and BOGGS, *Circuit Judges;* and DEMASCIO, *District Judge.**

MILBURN, *Circuit Judge.* Roth Steel Tube Company ("taxpayer") appeals from a decision of the United States Tax Court sustaining deficiencies in the amount of $1,728,802 determined by the Commissioner of Internal Revenue ("the Commissioner") with respect to taxpayer's federal income tax liability for the taxable years 1971 through 1975. The principal issue presented is whether taxpayer's unrepaid advances to a subsidiary corporation were loans deductible as bad debts under 26 U.S.C. § 166

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*Honorable Robert E. DeMascio, Judge, United States District Court, Eastern District of Michigan, sitting by designation.

or capital contributions deductible only to the extent of capital gains under 26 U.S.C. §1221. Because the Tax Court's factual determination that the advances were capital contributions and not loans is not clearly erroneous, we affirm.

I.

The facts are carefully set out in the opinion of the Tax Court, 79 T.C.M. (CCH) 698 (1985), and will only briefly be set forth here. Taxpayer is an Ohio corporation whose principal business activity during the years at issue was the manufacture and sale of steel tubing. In August 1972, taxpayer acquired sixty-two percent of the stock of Remco Industries, Inc. ("Remco"), a manufacturer of children's toys. Subsequent to taxpayer's acquisition of Remco, Remco's board of directors and key management personnel were replaced by taxpayer's personnel.

During the two years prior to its acquisition by taxpayer, Remco had sustained substantial losses from its operations. On January 21, 1971, Remco filed a petition for an arrangement under Chapter 11 of the Bankruptcy Act, and Remco's plan of arrangement was confirmed on April 28, 1971. Under the plan, Bankers Trust Company ("Bankers") was to advance $7,500,000 to Remco, and the advance was to be secured by a first mortgage in that amount on Remco's real estate and a security interest in all inventory owned or acquired by Remco. Remco was to use the amount borrowed from Bankers to pay existing indebtedness to Bankers of approximately $6,000,000 and to use the remainder to pay other creditors.

The plan of arrangement also provided that James Talcott, Inc. ("Talcott") would advance funds to Remco

to be secured by a security interest in Remco's accounts receivable, goods and chattels, inventory, warehouse receipts, and general intangibles. Talcott was also given a third mortgage on certain real estate owned by Remco and was assigned Remco's claim for federal income tax refund for the years 1968 and 1969. Talcott would advance $2,900,000 to Remco with an agreement to advance additional sums to Remco based on seventy-five percent of Remco's eligible accounts receivable. This agreement was subsequently modified to provide that Talcott, in its discretion, would lend up to $11,000,000 on a borrowing base of seventy-five percent of eligible accounts receivable and an additional $1,000,000 on a borrowing base of fifty percent of inventory value. The plan further provided that Remco would execute a second mortgage on its real estate and provide a subordinated security interest in its machinery, equipment, and inventory to William N. Otte ("Otte"), secretary to the creditor's committee of Remco, to secure payments due Remco's general creditors in the amount of $1,186,420.

The plan provided for repayment of the Bankers and Talcott loans. Remco was to make quarterly payments of principal to Bankers in the amount of $93,750 from August 1, 1971, through May 1, 1976, when a final installment in the amount of the unpaid balance of principal and accrued interest was to be made. Remco was also required to make quarterly payments of interest to Bankers. Other payments to Talcott and Bankers were to be made from collections on accounts receivable arising prior to January 21, 1971. Additionally, Remco was required to pay Bankers a percentage of after-tax, net income over the amount of $1,000,000. Otte was to be paid on the following schedule:

January 15, 1972	$ 50,000
April 26, 1972	$ 284,089
October 26, 1972	$ 284,111
April 26, 1973	$ 284,110
October 26, 1973	$ 284,110

Talcott was authorized to collect accounts receivable and to negotiate any payment made to Remco. Any loans made by Talcott pursuant to the agreement were payable on demand.

At the end of Remco's 1971 calendar year, Remco's balance sheet disclosed an excess of current assets over current liabilities of $1,106,263, but its total liabilities exceeded total assets by $3,046,072. Remco's statement of operations for 1971 reported a loss in the amount of $4,443,483. During 1972, Remco continued to experience financial difficulties, and, at the end of Remco's 1972 calendar year, Remco's balance sheet disclosed an excess of current liabilities over current assets in the amount of $2,698,762 and an excess of total liabilities over total assets in the amount of $5,925,175. Remco's statement of operations for 1972 reported a loss in the amount of $3,274,155. Assuming the sale of Remco's Harrison facility, Remco had total debts in the amount of $8,794,372 and total equity in the amount of $28,063.

In 1973, Remco introduced its new product line at the annual Toy Fair. Remco projected that it would have gross sales for 1973 of at least $22,000,000 and that net sales for 1973 would be approximately $19,000,000. Remco also projected that for 1973 it would have a total pre-tax net income of $550,000. Additionally, a cash availability analysis was prepared for 1973 which indicated that, after repayment of current loan obligations, cash receipts would exceed cash disbursements by $305,000. These projections were reviewed by taxpayer's management.

In 1972 and early 1973 Remco reached agreements with Bankers, Otte, and Talcott which permitted Remco to defer payments due each respective creditor. Bankers permitted Remco to pay the amount of $251,544.38 due on May 1, 1972, in monthly installments of $10,000 through December 29, 1972, when the balance of the amount due, together with interest, was to be paid. Bankers also agreed to an extension of the time for payment of approximately $360,000 of interest due for the period ending December 31, 1972. Otte permitted Remco to defer its final three payments of approximately $283,500 each, due on October 26, 1972, April 26, 1973, and October 26, 1973, under the plan of arrangement, to January 26, 1973, April 26, 1974, and October 26, 1974, respectively. Talcott permitted Remco to pay the $400,000 promissory note due on May 1, 1972, in monthly installments of $50,000, commencing on October 1, 1972, with the balance payable on December 31, 1972.

From November 3, 1972, through October 15, 1973, taxpayer made unsecured cash advances to Remco in the amount of $3,420,000. The advances, which were made to provide working capital needed for Remco's operations, included $587,850 from Roth Properties, Inc. ("Properties"), a subsidiary of taxpayer. With the exception of the $10,000 advance made on September 7, 1973, all the advances made by taxpayer to Remco were recorded on taxpayer's general ledger as receivables from Remco. On September 10, 1973, Remco repaid the $10,000 advance, and, in addition, Properties discharged the liability for payment of the advance made by taxpayer on its behalf in the amount of $587,850 as part of the purchase price for Remco's Harrison facility.

No interest was paid on any of these advances. Remco, however, reflected accrued interest expenses on its ac-

counting records, and taxpayer recorded "Interest Income —Remco" and "Interest Receivable—Remco" on its general ledger. Taxpayer reported some of the interest from Remco on its federal income tax returns for the years ending April 30, 1973, and April 30, 1974.

Although resolutions of Remco's board of directors directed its officers to execute notes evidencing the indebtedness, the advances were not evidenced by notes or other instruments of indebtedness. One resolution of taxpayer's board of directors authorized loans to Remco, and resolutions of Remco's board of directors approved receipt of advances from taxpayer in the aggregate amount of $2,997,150. Only the resolution of November 3, 1972, by Remco's board of directors approving receipts in the amount of $175,000 stated the period of the advance or the rate of interest payable. The resolution also provided, in pertinent part, that: "The directors deem it to be in the best interest of Remco to effect such borrowing from [taxpayer], which borrowing can be made on terms and at a rate of interest substantially more favorable and beneficial to Remco than are obtainable elsewhere."

Taxpayer's source of funds for the advances to Remco was its own capital sources, including loans from Society National Bank and Talcott. Society National Bank financed the initial advance to Remco in the amount of $175,000 but was unwilling to finance subsequent advances. Talcott agreed to make loans to taxpayer and its subsidiary corporations. The Talcott loans were secured by accounts receivable, inventory, equipment, real estate, guaranties, and other collateral. The loan agreement required that taxpayer and the subsidiary corporations advance $1,650,000 to Remco and required Remco to sell its Harrison facility to Properties. Properties and

Remco executed an agreement for the sale of the real estate on May 16, 1973. A purchase price of $7,500,000 was to be paid by Properties' assumption of the unpaid balance on the first mortgage held by Bankers and, as stated above, by assumption of liability for advances made by taxpayer to Remco on behalf of Roth Properties in the amount of $587,850.

Despite the new management and the infusion of additional funds, Remco continued to experience financial difficulties. For the periods ending February 4, 1973, and March 4, 1973, the actual results of operations were more favorable than had been projected. However, for the period ending April 1, 1973, through the period ending December 2, 1973, the actual results of operations were less favorable than projected due to a lower volume of net sales than anticipated. At the end of 1973, Talcott refused to make any further loans to Remco, and Remco discontinued operations because of a lack of working capital. Remco ceased operations in January of 1974, and its assets were turned over to Talcott.

On its federal income tax return for the fiscal year ending April 30, 1974, taxpayer claimed a deduction in the amount of $3,582,848 as a loss on its investment in the Remco stock and its advances to Remco. This claimed deduction resulted in a net operating loss for which taxpayer claimed carry-over deductions to offset its income for the fiscal year ending April 30, 1971, April 30, 1972, April 30, 1973, June 30, 1974, and June 30, 1975.

On audit the Commissioner determined that the losses claimed by taxpayer were capital losses which are deductible only to the extent of capital gains. Since taxpayer had no capital gains in that year, the Commissioner determined that no deduction was permitted. In addition,

the Commissioner disallowed taxpayer's net operating loss deductions for the other fiscal years that had been based on the deductions claimed for April 30, 1974 fiscal year. Taxpayer was issued a statutory notice of deficiency to that effect.

The Tax Court sustained the Commissioner's determination. The Tax Court found that taxpayer's loss on its investment in the Remco stock was capital, rather than ordinary, in nature. The Tax Court also found that taxpayer purchased the Remco stock as an investment and, as a result, taxpayer failed to establish that the purchase fell within the limited, judicially-created exception to the general rule that a loss sustained with respect to stock is treated as a capital loss. *See Corn Products Refining Co. v. Commissioner,* 350 U.S. 46 (1955).

The Tax Court disallowed taxpayer's claim to a deduction as bad debts under 26 U.S.C. § 166, for the advances it had made to Remco, finding that these advances were not loans but were instead capital contributions. The Tax Court thus concluded that all of taxpayer's losses were capital in nature which could be used only to offset capital gains.

Thereafter, taxpayer filed a motion to vacate the decision contending that all or, alternatively, various portions of the advances to Remco were loans and that it was entitled to deduct an accounts receivable in the amount of $50,730, which taxpayer claimed represented accrued, but unpaid, interest due from Remco. Pursuant to a memorandum order, the Tax Court denied taxpayer's motion. In that memorandum, the Tax Court again reviewed the evidence that led it to its finding that the advances were contributions to Remco's capital and were not loans. It further concluded that the taxpayer had

not presented evidence establishing its entitlement to a deduction with respect to the accounts receivable.

II. CAPITAL CONTRIBUTIONS OR LOANS

A. *Standard of Review*

Taxpayer argues that the Tax Court erred in finding that the advances to Remco were capital contributions rather than loans. A reviewing court may not set aside factual findings made by the Tax Court unless they are clearly erroneous. *See* 26 U.S.C. § 7482 (renders Rule 52(a) of the Federal Rules of Civil Procedure applicable to review of Tax Court decisions). Courts have, however, taken opposing views on whether the question of capital contributions versus loans is a question of law or fact. *See, e.g., Estate of Mixon v. United States,* 464 F.2d 394, 402-03 (5th Cir. 1972) (the question of capital contributions versus loans is primarily one of law subject to *de novo* review); *Bauer v. Commissioner,* 748 F.2d 1365, 1367 (9th Cir. 1984) (the question of capital contributions versus loans is one of fact subject to clearly erroneous review). This court has previously held that the question of whether advances to a corporation constitute capital contributions or loans is a question of fact. *Smith v. Commissioner,* 370 F.2d 178, 180 (6th Cir. 1966). Thus, we must review the Tax Court's determination that taxpayer's advances to its subsidiary corporation were capital contributions and not loans under the clearly erroneous standard.

B. *Analysis*

Bad debts which become worthless within the taxable year are deductible as ordinary losses under 26 U.S.C. § 166(a)(1). The right to a deduction is limited to gen-

uine debt, and capital contributions are not considered debt for the purposes of section 166(a)(1). *Raymond v. United States,* 511 F.2d 185, 189 (6th Cir. 1975). Capital contributions are added to the basis of the shareholder's stock, and, if the stock later becomes worthless, the shareholder is entitled to a capital loss. 26 U.S.C. § 165(g)(1).

The determination of whether advances to a corporation are loans or capital contributions depends on whether the objective facts establish an intention to create an unconditional obligation to repay the advances. *Raymond,* 511 F.2d at 190. "Advances between a parent corporation and a subsidiary . . . are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt'." *United States v. Uneco, Inc.,* 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting *Cuyuna Realty Co. v. United States,* 382 F.2d 298, 300-01 (Ct. Cl. 1967)). The taxpayer carries the burden of establishing that the advances were loans rather than capital contributions. *Smith,* 370 F.2d at 180.

This court has identified a number of factors to be used in making the capital contribution versus loan determination: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund

to provide repayments. *See Raymond,* 511 F.2d at 190-91; *Austin Village, Inc. v. United States,* 432 F.2d 741, 745 (6th Cir. 1970); *Berthold v. Commissioner,* 404 F.2d 119, 122 (6th Cir. 1968); *Smith,* 370 F.2d at 180. No one factor is controlling or decisive, and the court must look to the particular circumstances of each case. *Smith,* 370 F.2d at 180. We will consider each factor separately.

1. *Identity of Interest Between Creditor and Stockholder*

The Tax Court found that taxpayer owned only sixty-two percent of Remco's stock and that the other shareholders did not make proportionate advances to Remco. "If advances are made by stockholders in proportion to their respective stock ownership, an equity contribution is indicated. . . . A sharply disproportionate ratio between a stockholder's percentage interest in stock and debt is, however, strongly indicative that the debt is bona fide." *Estate of Mixon,* 464 F.2d at 409 (citations omitted); *see also* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 4.04, at 4-10 to 11 (1979) (hereinafter cited as Bittker & Eustice). Although a substantial disparity exists between taxpayer's holdings of debt and stock, this disparity alone is not fatal to debt classification. Bittker & Eustice, *supra,* at 4-11; *cf. Foresun, Inc. v. Commissioner,* 348 F.2d 1006, 1009 (6th Cir. 1965) (non-shareholder debt classified as equity notwithstanding disproportionate interests of creditors and shareholders).

2. *Adequacy or Inadequacy of Capitalization*

The Tax Court found that Remco was "seriously" under-capitalized and that "Remco's debt to equity ratio at December 31, 1972, was in excess of 300 to 1." Thin

or inadequate capitalization is strong evidence that the advances are capital contributions rather than loans. *See Bauer,* 748 F.2d at 1369; *see also Estate of Mixon,* 464 F.2d at 408; *Foresun,* 348 F.2d at 1009; Bittker & Eustice, *supra,* at 4-12. Advances made to a corporation whose debt to equity ratio exceeds 300 to 1 are indicative of venture capital rather than loans. *See Gilbert v. Commissioner,* 248 F.2d 399, 407 (2d Cir. 1957) (excessive debt structure indicate [sic] of venture capital).

2. [sic] *Source of Repayments*

The Tax Court found that repayment of the advances made by taxpayer were dependent on the financial success of Remco and that taxpayer could not have had a reasonable expectation of repayment at any time during the period in which the advances were made. If the expectation of repayment depends solely on the success of the borrower's business, the transaction has the appearance of a capital contribution. *Lane v. United States,* 742 F.2d 1311, 1314 (11th Cir. 1984); *Estate of Mixon,* 464 F.2d at 405. An expectation of repayment solely from corporate earnings is not indicative of bona fide debt regardless of its reasonableness. *See Lane,* 742 F.2d at 1314.

4. *Name Given Instruments Evidencing Indebtedness*

The Tax Court found that although taxpayer and Remco reported substantially all the advances as loans on their accounting records, no instruments of indebtedness were executed. The absence of notes or other instruments of indebtedness is a strong indication that the advances were capital contributions and not loans. *Stinnett's Pontiac Service, Inc. v. Commissioner,* 730 F.2d 634, 638 (11th Cir. 1984); *Raymond,* 511 F.2d at 191; *Estate*

of Mixon, 464 F.2d at 403. The entry of the advances as loans on the accounting records of both entities provides little if any support for a finding of bona fide debt. *Raymond*, 511 F.2d at 191.

5. *Presence or Absence of Fixed Maturity Date and Schedule of Payments*

The Tax Court found that the only advance for which the parties established a due date was the initial advance which, although scheduled to be repaid within sixty days, was never repaid at all. The absence of a fixed maturity date and a fixed obligation to repay indicates that the advances were capital contributions and not loans. *Lane*, 742 F.2d at 1316; *Stinnett's Pontiac*, 730 F.2d at 638-39; *Raymond*, 511 F.2d at 191; *Estate of Mixon*, 464 F.2d at 404.

6. *Presence or Absence of a Fixed Rate of Interest and Interest Payments*

The only indication of a rate of interest in this case was that taxpayer would charge Remco whatever rate it would have to pay to borrow the funds, and the Tax Court found that no interest payments were actually made. The absence of a fixed rate of interest and interest payments is a strong indication that the advances were capital contributions rather than loans. *Stinnett's Pontiac*, 730 F.2d at 640; *Raymond*, 511 F.2d at 191; *Austin Village*, 432 F.2d at 745.

7. *Presence or Absence of Security*

The Tax Court found that all taxpayer's advances to Remco were unsecured. The absence of security for the advances is a strong indication that the advances were capital contributions rather than loans. *Lane*, 742 F.2d at 1317; *Raymond*, 511 F.2d at 191; *Austin Village*, 432 F.2d at 745.

8. *Inability to Obtain Outside Financing*

The Tax Court found that Talcott was willing to make loans to Remco only on the condition of ample security as well as numerous other conditions that would enable it to recover its loans. The Tax Court also found that another commercial lender had declined to lend taxpayer funds for Remco's use. The fact that no reasonable creditor would have acted in the same manner as the taxpayer is strong evidence that the advances were capital contributions rather than loans. *Stinnett's Pontiac*, 730 F.2d at 640; *Estate of Mixon*, 464 F.2d at 410.

9. *Subordination of Advances*

The Tax Court found that taxpayer's only hope for repayment would be after obligations to Remco's other creditors were satisfied. Subordination of advances to claims of all other creditors indicates that the advances were capital contributions and not loans. *Stinnett's Pontiac*, 730 F.2d at 639; *Raymond*, 511 F.2d at 191; *Austin Village*, 432 F.2d at 745.

10. *Presence or Absence of a Sinking Fund*

The Tax Court found that the taxpayer looked solely to Remco's earnings for repayment of the advances. The failure to establish a sinking fund for repayment is evidence that the advances were capital contributions rather than loans. *Lane*, 742 F.2d at 1317; *Raymond*, 511 F.2d at 191; *Austin Village*, 432 F.2d at 745.

11. *Extent to Which the Advances Were Used to Acquire Capital Assets*

The Tax Court found that taxpayer's advances to Remco were for day-to-day operations rather than the purchase of capital assets. Use of advances to meet the daily

operating needs of the corporation, rather than to purchase capital assets, is indicative of bona fide indebtedness. *Stinnett's Pontiac,* 730 F.2d at 640; *Raymond,* 511 F.2d at 191; *Estate of Mixom,* 464 F.2d at 410.

Having considered these various factors, we cannot conclude that the Tax Court's finding that the taxpayer's advances were capital contributions and not bona fide loans is clearly erroneous. The fact that thirty-eight percent of Remco's stock was owned by shareholders who did not make proportionate advances and the fact that the advances were not used to acquire capital assets support taxpayer's argument. However, these two factors do not provide sufficient justification for rejecting the Tax Court's determination that, considering all the factors, the advances were capital contributions.

III. ORDINARY DEDUCTION FOR WORTHLESS SECURITIES

Taxpayer argues, for the first time on appeal, that the entire loss sustained as a result of its stockholdings in Remco, including any advances deemed capital contributions, are deductible as an ordinary loss under 26 U.S.C. § 165(g)(3). Under 26 U.S.C. § 165(g)(1), worthless securities give rise to a capital loss as of the last day of the taxable year in which the securities became worthless. However, a corporate taxpayer can obtain an ordinary loss for worthless stock under 26 U.S.C. § 165(g)(3) if the stock is held in an affiliated corporation. A corporation shall be treated as affiliated with the taxpayer if "80 percent of the voting power of all classes of its stock and at least 80 percent of each class of its non-voting stock" is owned directly by the taxpayer and if "more than 90 percent of the aggregate of its gross receipts for all taxable

years has been from sources other than royalties, rents . . ., dividends, interest . . ., annuities, and gains from sales or exchanges of stocks and securities." 26 U.S.C. § 165(g)(3).

We need not, however, address taxpayer's argument. The general rule is that issues not raised before the Tax Court are inappropriate for appellate consideration. *Cooper v. Commissioner*, 542 F.2d 599, 601 (2d Cir. 1976) (per curiam); *Adolph Coors Co. v. Commissioner*, 519 F.2d 1280, 1284 (10th Cir. 1975), *cert. denied*, 423 U.S. 1087 (1976); *Hayutin v. Commissioner*, 508 F.2d 462, 485 (10th Cir. 1974); *Livernois Trust v. Commissioner*, 433 F.2d 879, 883 (6th Cir. 1970); *Reeves v. Commissioner*, 314 F.2d 438, 439 (6th Cir. 1963). This rule is particularly applicable where, as here, resolution of the issue would require further factual determination. *See Dennis v. Commissioner*, 473 F.2d 274, 282 (5th Cir. 1973). Resolution of the issue raised by taxpayer would require a factual determination with respect to whether taxpayer satisfied the gross receipts test of section 165(g)(3).

IV. ORDINARY DEDUCTION FOR UNPAID INTEREST

Taxpayer argues, in a wholly conclusory fashion, that it should be allowed an ordinary deduction in the amount of $50,730 designated as "Accounts Receivable—Remco Industries, Inc." According to taxpayer, this amount represents accrued but unpaid interest on its advances to Remco. The Commissioner, in his notice of deficiency, characterized this amount as a capital loss, but urged in his brief before the Tax Court that no deduction should be allowed. The taxpayer, in its reply brief, argued that the amount was deductible as an ordinary loss. The Tax Court refused to consider the issue stating that neither party had

presented evidence sufficient to permit determination of the deductibility of this amount. The Tax Court further observed that taxpayer had failed to carry its burden of proving that this amount was "interest receivable which had been included in its income."

The Commissioner's determination of a tax deficiency is presumptively correct, and the burden of disproving the deficiency rests with the taxpayer. *BASF Wyandotte Corp. v. Commissioner,* 532 F.2d 530, 538 (6th Cir. 1976). In order to establish an entitlement to an ordinary deduction, taxpayer would have had to show, at a minimum, that this amount was reported as income. *See Maryland Savings-Share Insurance Corp. v. United States,* 644 F.2d 16, 27 n.14 (Ct. Cl. 1981); *W. L. Moody Cotton Co. v. Commissioner,* 143 F.2d 712, 714 (5th Cir. 1944). Taxpayer failed to make the required showing and, therefore, was not entitled to an ordinary deduction.

V.

Accordingly, the decision of the Tax Court is AFFIRMED.

APPENDIX B

T.C. Memorandum Opinion 1985-58 of the United States Tax Court

(Filed February 7, 1985)

Docket No. 517-78

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

ROTH STEEL TUBE COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

HAMBLEN, *Judge*: Respondent determined the following deficiencies in petitioner's Federal income taxes:

Taxable Years Ended	Deficiencies
April 30, 1971	$214,769
April 30, 1972	144,044
April 30, 1973	114,826
April 30, 1974	579,053
June 30, 1974	211,431
June 30, 1975	464,679

After concessions[1] the issues for decision are (1)

1. In its petition petitioner claimed that it had properly made additions to its reserve for bad debts in each of its taxable years ending April 30, 1973, April 30, 1974, June 30, 1974, and June 30, 1975. The burden of proving that such additions are

(Continued on following page)

whether Exhibit 59, "Request for Credit Line" and "Remco Industries, Inc. Credit Line Comments," is inadmissable as hearsay evidence; (2) whether petitioner may deduct the amounts paid to acquire the stock of Remco Industries, Inc. ("Remco"), as an ordinary loss under section 165(a)[2] for the taxable year ending April 30, 1974; (3) whether petitioner may deduct the amount of $2,873,814 designated as advances to Remco as a bad debt loss under section 166(a) for the taxable year ending April 30, 1974;[3] (4) whether petitioner is entitled to net operating loss deductions under section 172(a) for the taxable years ending April 30, 1971, April 30, 1972, April 30, 1973, June 30, 1974, and June 30, 1975.

Footnote continued—

reasonable is on petitioner. *Roth Steel Tube Co. v. Commissioner* [Dec. 34,416], 68 T. C. 213, 218 (1977), aff'd [80-1 USTC ¶ 9410] 620 F. 2d 1176 (6th Cir. 1980). Petitioner neither introduced evidence to meet its burden of proof nor raised the issue of the reasonableness of the bad debt reserve in its trial memorandum or briefs submitted in support of its position. Consequently, we assume that petitioner has conceded that the additions to its bad debt reserve are not deductible under sec. 166(c). In any event petitioner has introduced no evidence and has not met its burden of proof.

2. Unless otherwise specified, all section references are to the Internal Revenue Code of 1954, as amended and in effect for the taxable years at issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

3. Respondent raises the issue of whether any deduction is allowable for the amount of $51,664 for the first time on brief. In his notice of deficiency respondent characterized this amount as a capital loss allowable to the extent of capital gains under sec. 1211(a). Petitioner responded to this issue on brief claiming that the record supports its contention that this amount is deductible as an ordinary loss. We decline to further consider this issue as neither party has presented any conclusive evidence in this respect.

Findings of Fact

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner was an Ohio corporation with its principal place of business in Pepper Pike, Ohio, when its petition was filed in this case. Petitioner's principal business activity during the years at issue was the manufacture and sale of steel tubing. Petitioner owned all or a substantial portion of the stock of several subsidiary corporations. During the taxable years ending April 30, 1973, and April 30, 1974, petitioner owned all of the stock of Toledo Steel Tube Co. ("Toledo"), Roshel Industries, Inc. ("Roshel"), and Roth American, Inc. ("American") and approximately 62 percent of the stock of Remco.

The Remco stock was publicly traded on the Over-The-Counter Market. By agreement dated as of August 1, 1972, petitioner acquired 1,158,017 shares or approximately 62 percent of the issued and outstanding shares of Remco common stock. The purchase price for these shares was $.4629 per share. Petitioner acquired an additional 3,032 shares of Remco common stock pursuant to a tender offer made on August 18, 1972. The purchase price for the shares acquired pursuant to the tender offer was $.50 per share, the par value of the common stock. At the conclusion of these transactions petitioner owned 1,161,049 shares of Remco common stock with a cost basis of $553,062. This amount was recorded on petitioner's General Ledger as "INVESTMENTS—REMCO INDUSTRIES."

Remco was formerly the parent of American, Petitioner acquired all of the stock of American from Remco

in 1971. Prior to the sale of the American stock to petitioner, American had experienced financial difficulties, and Remco planned to file a petition for an arrangement under chapter XI of the Bankruptcy Act for American. Herbert Gurbst ("Gurbst"), then a principal officer with American, convinced Remco not to file a bankruptcy petition for American and began a concerted effort to save American. Gurbst was appointed as president of American. Under Gurbst's management American's gross sales and losses from operations as reported on its Forms 1120, U. S. Corporate Income Tax Returns, indicated that American was recovering from its previous financial difficulties.

Remco was incorporated in 1950 under the laws of the State of New Jersey and had its principal office and manufacturing operations on Cape May Street, Harrison, New Jersey. American had its operating facilities in Wilkes-Barre, Pennsylvania. The Harrison, New Jersey facility ("Harrison facility") used by Remco was approximately seven or eight years old in 1972 and contained about 600,000 square feet of which it used only one-half. The Wilkes-Barre, Pennsylvania facility used by American was 95 years old. One of the factors which petitioner considered when purchasing the stock of Remco was the potential use of the Harrison facility by petitioner and its affiliates. By October of 1972 some of the operations had been moved to the Harrison facility.

Both Remco and American manufactured children's toys. American's main product lines included swing sets, hobby horses, pre-school age desks and blackboards. Sales of these types of toys are not highly seasonal. Remco's product lines included activity toys, dolls and doll accessories, craft sets, and pre-school toys. Sales of these types of toys are seasonal. Because Remco's product lines

were seasonal and American's product lines were not highly seasonal, Gurbst as president of American felt that it would be advantageous to both companies to combine their operations in one facility in order to reduce overhead and assist Remco in developing a year-round operation.

Remco introduced its product line for the year at the Toy Fair held in February of each year. From the response of buyers at the Toy Fair in February of 1973, it was predicted that Remco would have gross sales for 1973 of at least $22,000,000 and that net sales for 1973 would be approximately $19,000,000. Most of the orders for these products would be placed during the first six months of the year. The toys were to be manufactured from the beginning of March through October or the middle of November. It was anticipated that $15,000,000 of the net sales would be shipped from June through December of 1973. Payment for these shipments would be made from December of 1973 through February of 1974.

Subsequent to petitioner's acquisition of Remco, the members of Remco's board of directors and key management personnel resigned. These positions were filled by personnel affiliated with petitioner.

Prior to its acquisition by petitioner, Remco had experienced financial reverses. During the two years immediately preceding its acquisition by petitioner, Remco had sustained substantial losses from continuing operations. On January 21, 1971, Remco filed a petition for an arrangement under chapter XI of the Bankruptcy Act. An Order confirming Remco's plan of arrangement was issued on April 28, 1971.

Under the plan of arrangement Bankers Trust Company ("Bankers") was to advance $7,500,000 to Remco,

Remco's obligation to repay this sum was to be secured by a first mortgage in the amount of $7,500,000 on Remco's real estate and a security interest in all inventory owned or acquired by Remco. Pursuant to an agreement dated April 23, 1971, Remco was to use the amount borrowed from Bankers to pay existing indebtedness to Bankers of approximately $6,000,000 and to use the excess proceeds to pay the balance due to The Mutual Life Insurance Company.

The plan of arrangement also provided that James Talcott, Inc. ("Talcott") would advance funds to Remco to be secured by security interests in accounts receivable, goods and chattels, inventory, warehouse receipts, and general intangibles. Talcott was also given a third mortgage on certain real estate owned by Remco. In addition Remco assigned any claim for a Federal income tax refund for year 1968 and 1969 to Talcott. Initially, the amount of the advance made by Talcott to Remco was $2,900,000 with an agreement to advance additional sums to Remco based on 75 percent of Remco's eligible receivables. This agreement was modified by letter agreement dated May 11, 1972, which provided that Talcott in its discretion, would lend up to $11,000,000 on a borrowing base of 75 percent of eligible receivables and an additional $1,000,000 on a borrowing base of 50 percent of inventory value.

Finally, the plan of arrangement provided that Remco would execute a second mortgage on its real estate and provide a subordinated security interest on its machinery, equipment and inventory to William N. Otte, ("Otte"), Secretary to the Creditors Committee of Remco, who represented the former unsecured, general creditors of Remco. These interests were to secure deferred, installment payments due in the amount of $1,186,420.

The plan of arrangement specifically provided for repayment of the Bankers and Talcott loans. Remco was to make quarterly payments of principal to Bankers in the amount of $93,750 from August 1, 1971, through May 1, 1976, when a final installment in the amount of the unpaid balance of principal and accrued interest was to be made. Remco was also required to make quarterly payments of interest to Bankers. Other payments to Talcott and Bankers were to be made from collections on accounts receivable arising prior to January 21, 1971. In addition Remco was required to pay Bankers a percentage of after-tax, net income over the amount of $1,000,000. Finally, Otte was to be paid the following amounts:

January 15, 1972	$ 50,000
April 26, 1972	284,089
October 26, 1972	284,111
April 26, 1973	284,110
October 26, 1973	284,110
	$1,186,420

The Financing Agreement executed by Talcott and Remco provided, in pertinent part:

> 2. * * * You [Talcott] or your designee may notify customers or account debtors at any time that Receivables have been assigned to you or of your security interest therein, collect them directly and charge the collection costs and expenses to our account but, unless and until you do so or give us other instructions, we shall make collection of all Receivables for you, receive all payments thereon as your trustee and immediately deliver them to you in their original form. * * *

> 6. * * * We [Remco] appoint you [Talcott], your nominee or any other person whom you may designate as our attorney, with power: to endorse our name on any checks, notes, acceptances, money orders, drafts or other forms of payment or security that may come into your possession; to sign our name on any invoice or bill of lading relating to any Receivables, on drafts against customers, on schedules and assignments of Receivables, on notices of assignment, financing statements and other public records, * * * to notify the post office authorities to change the address for delivery of our mail to an address designated by you; to receive, open and dispose of all mail addressed to us; * * * This power, being coupled with an interest, is irrevocable so long as any Receivables assigned to you or in which you have a security interest remain unpaid or until the Obligations have been fully satisfied. * * *

The Financing Agreement with Talcott also provided that any loans made pursuant to the agreement or any supplement thereto would be payable on demand.

At the end of Remco's 1971 calendar year, Remco's balance sheet disclosed an excess of current assets over current liabilities of $1,106,263 but an excess of total liabilities over total assets of $3,046,072.[4] Remco's statement of operations for 1971 reported a loss from continuing operations in the amount of $4,443,483. During 1972 Remco continued to experience financial problems. In the purchase agreement executed by petitioner and the majority shareholders of Remco, Remco's financial condition was described as follows:

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4. This amount does not reflect any revaluation surplus created by appreciation in the real property owned by Remco, or any appreciation or depreciation in any other asset.

> Through December 31, 1971, the Corporation had substantial losses from operations which impaired capital. Substantial additional losses from operations have been incurred since December 31, 1971 resulting in a further impairment of capital. The future of the Corporation as an operating business will depend upon its ability to operate profitably and the availability of such financing as may be required.

At the end of Remco's 1972 calendar year, Remco's balance sheet disclosed an excess of current liabilities over current assets in the amount of $2,698,762 and an excess of total liabilities over total assets in the amount of $5,925,175.[5] Remco's statement of operations for 1972 reported a loss from continuing operations in the amount of $3,274,155.[6] Assuming the sale of the Harrison facility Remco had total debts in the amount of $8,794,372 and total equity in the amount of $28,063.[7]

In 1973 Remco prepared projections of monthly income or loss from operations and balance sheet amounts.[8]

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5. See Note 4. Pro-forma balance sheet amounts for 1972 were prepared reflecting the effect of the sale of the Harrison facility owned by Remco and the assumption of the Bankers mortgage by the purchaser. Using the pro-forma amounts, Remco's current assets exceeded current liabilities by $1,095,378 and total assets exceeded total liabilities by $28,063.

6. Remco changed its method of computing depreciation from accelerated to straight-line for all assets other than real estate, effective January 1, 1972. This change resulted in a decrease in net loss for the year of approximately $34,900. In 1972 Remco also extended the period for amortization of costs of new product development, dies and molds from three years to five years resulting in a $202,576 decrease in net loss for 1972.

7. Included in the total debt amount is an advance from petitioner of $175,000.

8. There is no indication as to when these projections were prepared. However, it is clear from the record that they were prepared after January 10, 1973.

Each projected amount was compared to actual operations at the end of the month. The projections indicated that Remco would have a total pre-tax net income of $550,000 for 1973. In addition a cash availability analysis was prepared which indicated that cash receipts would exceed cash disbursements, after repayment of current loan obligations to Talcott and Otte, by a total of $305,000 for 1973. The cash availability analysis was based on the assumption that the Harrison facility owned by Remco had been disposed of at the beginning of 1973 resulting in the elimination of the liability to Bankers. The cash availability analysis also assumed that cash receipts would include further loans from Talcott based on 75 percent of Remco's receivables and advances from petitioner or its related entities in the amount of $2,050,000. The projections were reviewed by the management of petitioner.

In 1972 and early 1973 Remco reached agreements with Bankers, Otte, and Talcott which permitted Remco to defer payments due to each respective creditor. By letter agreement dated May 10, 1972, Bankers permitted Remco to pay the amount of $251,544.38 due on May 31, 1972, for Remco's $7,500,000 obligation to Bankers in monthly installments of $10,000 through December 29, 1972, when the balance of the amount due together with interest was to be paid. Subsequently the record indicates that Bankers agreed to extension of time for the payment of approximately $360,000 of interest due for the period ending December 31, 1972. The agreement with Otte permitted Remco to defer its final three payments of approximately $283,500 each due on October 26, 1972, April 26, 1973, and October 26, 1973, under the plan of arrangement to January 26, 1973, April 26, 1974, and October 26, 1974, respectively. The letter agreement with Talcott dated May 11, 1972, permitted Remco to

pay the $400,000 promissory note due on May 1, 1972, in monthly installments of $50,000 commencing on October 1, 1972, with the balance payable at December 31, 1972.

Beginning on November 3, 1972, petitioner made unsecured cash advances to Remco. The amounts and dates of these advances were:

Date of Advance	Amount of Advance
November 3, 1972	$ 175,000
January 12, 1973	90,000
January 19, 1973	50,000
January 22, 1973	70,000
January 26, 1973	410,000
February 2, 1973	100,000
February 5, 1973	75,000
February 6, 1973	75,000
February 7, 1973	75,000
February 9, 1973	55,000
February 10, 1973	100,000
February 16, 1973	100,000
February 20, 1973	60,000
February 21, 1973	50,000
February 23, 1973	115,000
March 3, 1973	100,000
March 5, 1973	185,000
March 9, 1973	150,000
March 12, 1973	50,000
March 16, 1973	100,000
March 19, 1973	60,000

Date of Advance	Amount of Advance
March 24, 1973	$ 50,000
March 30, 1973	65,000
April 6, 1973	100,000
April 13, 1973	25,000
April 16, 1973	50,000
April 19, 1973	50,000
April 24, 1973	25,000
April 27, 1973	25,000
May 1, 1973	85,000
May 7, 1973	50,000
May 8, 1973	40,000
May 21, 1973	75,000
June 22, 1973	100,000
July 2, 1973	75,000
July 5, 1973	50,000
July 6, 1973	75,000
July 17, 1973	50,000
July 18, 1973	50,000
August 8, 1973	50,000
September 7, 1973	10,000
October 15, 1973	75,000
Total	$3,420,000

The advances were made to provide working capital needed for Remco's operations and were made at the request of Edmund Rossi who was controller and subsequently general manager of Remco based on his determinations of the cash needs of Remco. The advances were then approved by Jack Falcon, vice-president of finance of peti-

tioner, or Leonard Roth ("Roth"), chairman of the board of petitioner.

Included in the above enumerated advances is the amount of $587,850 which represents advances made to Remco on behalf of Roth Properties, Inc. ("Properties"), an affiliate of petitioner. With the exception of the advance made on September 7, 1973, all of the advances made by petitioner to Remco were recorded on petitioner's General Ledger as receivables from Remco. These amounts were recorded on Remco's books as payables.

Remco repaid the $10,000 advance made on September 7, 1973, on September 10, 1973. Properties, in effect, assumed the liability for payment of advances in the amount of $587,850 as part of the purchase price for Remco's Harrison facility. No other amounts due to petitioner from Remco were paid or assumed by another party.

No interest was paid on any of these advances. However, Remco reflected accrued interest expense on its accounting records, and petitioner recorded "Interest Income —Remco" and "Interest Receivable—Remco" on its General Ledger. Petitioner reported interest income from Remco on its Forms 1120, U. S. Corporation Income Tax Returns, for the years ending April 30, 1973, and April 30, 1974.[9]

The advances were not evidenced by notes or other instruments of indebtedness. However, one resolution of petitioner's board of directors authorized loans to Remco,

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9. Petitioner did not report the full amount of interest reflected as a receivable from Remco as interest income on its Forms 1120, U. S. Corporation Income Tax Returns, for the years ending April 30, 1973, and April 30, 1974. This discrepancy was explained by Norbert S. Bick, petitioner's accountant and auditor who testified that a portion of the amounts which normally would have been recorded as interest income were actually credited to interest expense, reducing the total interest expense amount.

and resolutions of Remco's board of directors approved receipt of advancements from petitioner in the aggregate amount of $2,997,150. The resolutions of Remco's board of directors directed its officers to execute notes evidencing the indebtedness. Only the resolution of November 3, 1972, by Remco's board of directors, approving receipts in the amount of $175,000, stated the period of the advance or the rate of interest payable. This resolution also provided, in pertinent part, that:

> [T]he Directors deem it to be in the best interests of [Remco] to effect such borrowing from [petitioner], which borrowing can be made on terms and at a rate of interest substantially more favorable and beneficial to [Remco] than are obtainable elsewhere.

Petitioner's source of funds for the advances to Remco were its own capital sources, including loans from Society National Bank and Talcott. Society National Bank had financed the initial advance to Remco in the amount of $175,000 but had been unwilling to finance subsequent advances. Pursuant to a loan agreement between Talcott, petitioner, Roth Steel Products Company, Toledo, American, and Roshel, effective as of January 24, 1973, Talcott agreed to make loans to petitioner and the other signatory corporations. The Talcott loans were secured by accounts receivable, inventory, equipment, real estate, guaranties and other collateral. The loan agreement required, in part, that petitioner and the other signatory corporations advance $1,650,000 to Remco. These advances were to be evidenced by appropriate documentation, copies of which would be furnished to Talcott. Petitioner's president was authorized to execute such documentation. The loan agreement did not prohibit the lending corporation from perfecting a security interest in Remco's assets, although a prior agree-

ment between Remco and Talcott would require that Talcott consent to the creation of such a security interest. Talcott also continued to make loans directly to Remco.

In addition the terms of the loan agreement required the sale of Remco's Harrison facility to Properties. Properties and Remco executed an agreement for the sale of the real estate on May 16, 1973. The purchase price of $7,500,000 was to be paid by Properties' assumption of the unpaid balance on the first mortgage held by Bankers and by assumption of liability for advances made by petitioner to Remco in the amount of $587,850.

On the same date as the sale of the real estate, Properties and Remco executed a lease agreement which provided that Remco would lease the real estate it had sold to Properties for a term of ten years commencing on January 1, 1973. The rental for this property was $83,333.33 per month. Remco was to pay all real estate taxes and utilities related to the property, purchase and pay for insurance for the property, and repair and maintain the property.

Despite the new management and infusion of additional funds, Remco continued to experience financial difficulties through 1973. For the periods ending February 4, 1973, and March 4, 1973, the actual results of operations were more favorable than projected. However, actual results of operations were less favorable than projected for the period ending April 1, 1973, through the period ending December 2, 1973. These variances were due, in part, to a lower volume of net sales billed than anticipated. Net sales actually billed as compared to the projected figures for these periods were:

Period Ended	Net Sales Actually Billed	Projected Net Sales Billed[10]	Variance
4/ 1/73	$ 717,000	$ 785,000	$ 68,000
5/ 6/73	895,000	960,000	65,000
6/ 3/73	856,000	1,290,000	434,000
7/ 1/73	1,345,000	1,790,000	445,000
8/ 5/73	1,236,000	1,785,000	549,000
9/ 2/73	1,914,000	2,530,000	616,000
9/30/73	1,983,000	3,460,000	1,477,000
11/ 2/73	2,706,000	4,125,000	1,419,000
12/ 2/73	1,529,000	2,230,000	701,000

At the end of 1973 Talcott indicated that it would make no further loans to Remco, and Remco determined operations should be discontinued because of lack of working capital for the succeeding season. Remco ceased operations in January of 1974, and its assets were turned over to Talcott.

Petitioner claims that as a result of the discontinuance of Remco's operations it is entitled to ordinary deductions in the aggregate amount of $3,426,876 representing the cost of acquisition of Remco's shares in the amount of $553,062 and advances to Remco in the amount of $2,873,814. Respondent maintains that the total amount claimed as an ordinary deduction by petitioner is an investment loss which is characterized as a capital loss. As petitioner had no gains from the sale or exchange of capital assets during the periods at issue, such a capital loss would not be available to reduce petitioner's taxable income for these periods.

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10. For periods ending September 2, 1973, September 30, 1973, November 2, 1973, and December 2, 1973, projected net sales billed are pursuant to original projections.

Opinion

As a preliminary matter we must consider the admissibility of Exhibit 59, "Request for Credit Line" and "Hemco Industries, Inc. Credit Line Comments." Attached to the documents is the affidavit of Vito J. Ascatigno, assistant vice president of Talcott from June of 1962 to February of 1974. In the affidavit Mr. Ascatigno avers that he had personal knowledge of both documents.

Petitioner claims that it offers this exhibit merely to demonstrate that Talcott made an investigation into Remco's financial status in May of 1973, not to demonstrate that the information contained therein was correct. In the alternative petitioner claims that the exhibit is admissible as a business record. Respondent contends that the use of the document to prove that an investigation was conducted by Talcott renders the document inadmissible as hearsay, not subject to any of the exceptions to the general rule of exclusion.

The Federal Rules of Evidence apply to trials conducted in this Court. Sec. 7453; Rule 143(a). Under the Federal Rules of Evidence, hearsay is defined as "a statement * * * offered in evidence to prove the truth of the matter asserted." Fed. R. Evid. 801(c). Hearsay generally is inadmissible. Fed. R. Evid. 802. However, there are several exceptions to the general rule of inadmissibility. Included among these exceptions is Fed. R. Evid. 803(6) which describes, in pertinent part, those documents subject to the exception as:

> A memorandum, report, record, or data compilation, in any form, of acts, events, conditions, opinions, or diagnoses, made at or near the time by, or from information transmitted by, a person with knowledge, if

> kept in the course of a regularly conducted business activity, and if it was the regular practice of that business activity to make the memorandum, report, record, or data compilation, *all as shown by the testimony of the custodian or other qualified witness,* * * * [Emphasis Added]

In this instance the documents contained in Exhibit 59 are not offered to prove the truth of the matters asserted therein but merely to show that an investigation was undertaken by Talcott. For this limited purpose the documents are not hearsay within the definition of Fed. R. Evid. 801(c). However, the statements contained in the document are hearsay within the definition of Fed. R. Evid. 801(c). These statements are not admissible to prove the truth of the matters asserted therein under the exception contained in Fed. R. Evid. 803(6) as neither the custodian nor any other qualified witness testified at the trial of the case. The affidavit submitted with the documents is not sufficient to satisfy this requirement as our rules clearly state that an ex parte affidavit is not evidence. Rule 143(b).

We must next consider petitioner's claim that the amounts expended to acquire Remco's stock are deductible as an ordinary loss under section 165(a) for its taxable year ending April 30, 1974. Respondent maintains that this loss is a capital loss, allowable only to the extent of capital gains under section 1211(a). Resolution of this issue depends on whether the Remco stock was a capital asset in the hands of petitioner.

Section 1221 defines capital assets as "property held by the taxpayer (whether or not connected with his trade or business)." Five types of property are specifically excluded from the definition of capital assets. Sec.

1221(1)-(5). It is clear that the Remco stock owned by petitioner does not fall within any of the five exceptions.

The exceptions to the definition of capital assets enumerated in section 1221 are not exclusive, and a further exception has been judicially recognized. *Corn Products Refining Co. v. Commissioner* [55-2 USTC ¶ 9746], 350 U. S. 46 (1955). See also *Foy v. Commissioner* [Dec. 41,823], 84 T. C. — (filed Jan. 14, 1985). Under this judicially recognized exception "profits and losses arising from the everyday operation of a business [are] considered as ordinary income or loss rather than capital gain or loss." *Corn Products Refining Co. v. Commissioner, supra* at 52. In *Corn Products* the taxpayer acquired corn futures to insure an adequate supply of raw corn at a price that would permit its finished products to compete successfully in the market. The Supreme Court upheld the findings of this Court and the Court of Appeals for the Second Circuit that, in such circumstances, the corn futures were not capital assets in the hands of the taxpayer as they were an integral part of the taxpayer's manufacturing business.

This Court and others have applied the rule enunciated in *Corn Products* in situations involving the purchase of stock of another corporation. *W. W. Windle Co. v. Commissioner* [Dec. 33,602], 65 T. C. 694, 707-708 (1976) and cases cited therein.[11] In *W. W. Windle Co.* we concluded that such stock could be a capital asset even in a "mixed" motive situation and held that "where a substantial investment motive exists in a predominantly business-motivated acquisition of corporate stock, such stock is a capital asset." *W. W. Windle Co. v. Commissioner, supra* at 713. The substantial investment motive may exist at the time

11. See also *Bell Fibre Products Corp. v. Commissioner* [Dec. 34,263(M)], T. C. Memo. 1977-42.

of acquisition of the stock or during the period the stock is retained. *Arkansas Best Corp. v. Commissioner* [Dec. 41,581], 83 T. C. 640, 653-654 (1984).[12]

Petitioner claims that the Remco stock was purchased in order to assist it in increasing its East coast sales, to reduce the overhead of petitioner and its affiliates, and to facilitate American's operations. Petitioner argues that the factual circumstances involved herein are similar to those in *John J. Grier Co. v. U. S.*, 216 F. Supp. 928 (N. D. Ill. 1963), affd. [64-1 USTC ¶ 9266] 328 F. 2d 163 (7th Cir. 1964), where the court held that a loss on the sale of the stock of the subsidiary corporation was an ordinary loss. Petitioner also argues that it had a business motive within the definition adopted by *Datamation Services, Inc. v. Commissioner* [Dec. 33,973(M)], T. C. Memo. 1976-252. Consequently, petitioner maintains that it is entitled to an ordinary loss on its Remco stock at the time that Remco ceased operations. For the reasons discussed below, we do not agree.

Initially we note that many of the reasons cited by petitioner for its acquisition of the Remco stock relate to the business of its subsidiaries. Gurbst testified that he had urged petitioner to acquire Remco in order to combine the operations of Remco and American at the Harrison facility. Gurbst also testified that this would enhance operations of both corporations by reducing combined overhead and permitting year-round operations. Further Gurbst testified that the operations of petitioner and its other affiliates would be benefitted by the availability of

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12. In situations where stock is originally purchased for a business purpose and such business motive disappears leaving pure investment intent for continued retention, see *W. W. Windle Co. v. Commissioner* [Dec. 33,602], 65 T. C. 694, 714, n. 15 (1976).

the Harrison facility. Gurbst's testimony was corroborated by the testimony of Roth.[13] The testimony of Gurbst and Roth indicate that the stock acquisition was primarily intended to be, in effect, an investment in petitioner's operating subsidiaries. Consequently we cannot find that the Remco stock was acquired or retained primarily to benefit petitioner's own business operation.

Further, even had petitioner demonstrated that the acquisition and retention of the Remco stock was predominantly motivated to benefit its own business operations, the record also amply supports the conclusion that petitioner had a substantial investment purpose when it acquired and retained the Remco stock. Gurbst and Roth testified that petitioner anticipated that Remco could continue its operations through commercial loans and its sales. Gurbst also testified that Remco had at least one significant product at the time of petitioner's acquisition which was projected to generate five or six million dollars in sales. In addition Gurbst testified that he anticipated that a new product would be introduced through Remco which would generate additional sales. Finally, Gurbst testified that petitioner planned to reduce overhead and improve operations by infusing new management into Remco. Implementation of these plans, in the opinion of Gurbst, would permit Remco to become an independent operating entity. This contemplated financial recovery under new management was consistent with petitioner's experience

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13. We note that Roth's testimony was, in part, inconsistent with his prior statements. Roth testified that, to his knowledge, Properties was not actively pursuing acquisition of commercial properties. However, Roth signed a protest relating to Properties' taxable years ending in 1969 through 1972 which states, in pertinent part, "[p]rior to and during the years here at issue [Properties] actively pursued acquisition of new commercial realty."

with American which by 1972 had significantly reduced losses as reported on its Forms 1120, U. S. Corporation Income Tax Returns.

All of the above factors indicate that petitioner viewed its acquisition and retention of the Remco stock as an advantageous investment in a company which, with proper management, could become profitable. We can only conclude from this record that petitioner had a substantial investment motive when it acquired and retained the Remco stock. A substantial investment motive at the time of acquisition or retention of the stock requires treatment as a capital asset. *Arkansas Best Corp. v. Commissioner, supra; W. W. Windle Co. v. Commissioner, supra* at 712-714.

As the Remco stock was a capital asset, the loss on this asset would be a capital loss, allowable only to the extent of capital gains under section 1211(a). Petitioner reported no capital gains for its taxable year ending April 30, 1974. Consequently, we must sustain respondent's determination that no loss attributable to petitioner's investment in the Remco stock is allowable for its taxable year ending April 30, 1974.

We must next consider petitioner's claim that it is entitled to an ordinary deduction for its taxable year ending April 30, 1974, for a bad debt loss on the advances made to Remco in the amount of $2,873,814.[14] Petitioner asserts that these amounts represent bona fide indebtedness. Respondent maintains that these amounts were a contribution

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14. This amount, in part, represents total advances in the amount of $3,420,000 less the repayment of $10,000 made by Remco on September 10, 1973, and the liability of $587,850 assumed by Properties. The remaining amount is attributable to $51,664 designated as accounts receivable from Remco. As discussed *supra* at Note 3, we have declined to consider the deductibility of this amount as a separate issue.

to capital and that any loss should be characterized as a capital loss, allowable only to the extent of capital gains under section 1211(a).

There is no one characteristic which is decisive in the determination of whether funds advanced to a corporation are capital contributions or debt. *John Kelley Co. v. Commissioner* [46-1 USTC ¶ 9133], 326 U. S. 521, 530 (1946). Characterization of such funds as capital contributions or debt must be answered by reference to all the evidence. *Dixie Dairies Corp. v. Commissioner* [Dec. 36,987], 74 T. C. 476, 493 (1980). The usual presumption of the correctness of respondent's determinations applies in making the determination as to the nature of the advances. *Gooding Amusement Co. v. Commissioner* [Dec. 20,681], 23 T. C. 408, 421 (1954), affd. [56-2 USTC ¶ 9808] 236 F. 2d 159 (6th Cir. 1956).

In resolving the issue of whether such advanced funds are a capital contribution or debt, this Court and others have considered a myriad of factors. *Dixie Dairies Corp. v. Commissioner, supra* at 493. Among the factors considered are: (1) the manner of reporting the advances on the books of the parties involved; *Byerlite Corp. v. Williams* [61-1 USTC ¶ 9138] 286 F. 2d 285, 290 (6th Cir. 1960); *Litton Business Systems, Inc. v. Commissioner* [Dec. 32,263], 61 T. C. 367, 378 (1973); (2) the identity of interest between the transferor of funds and stockholder; *Fin Hay Realty Co. v. United States* [68-2 USTC ¶ 9438], 398 F. 2d 694, 696 (3d Cir. 1968); *Smith v. Commissioner* [67-1 USTC ¶ 9109], 370 F. 2d 178, 180 (6th Cir. 1966); (3) use of the amounts received; *Estate of Mixon v. United States* [72-2 USTC ¶ 9537], 464 F. 2d 394, 402 (5th Cir. 1972); *Wood Preserving Corp. of Baltimore v. United States* [65-2 USTC ¶ 9509], 347 F. 2d 117, 120 (4th Cir. 1965);

(4) the length of the transaction; *Byerlite v. Williams, supra* at 291; (5) actual repayment of the advances comporting with the terms of the transaction; *Mixon v. United States, supra* at 402, *Gooding Amusement Co. v. Commissioner, supra* at 419; (6) the ratio of debt to equity; *J. S. Biritz Construction Co. v. Commissioner* [68-1 USTC ¶ 9118], 387 F. 2d 451, 459 (8th Cir. 1967); *Post Corp. v. United States* [81-1 USTC ¶ 9197], 640 F. 2d 1296, 1307 (Ct. Cl. 1981); (7) security provided for the repayment of the advances; *A. R. Lantz Co. v. United States* [70-1 USTC ¶ 9308], 424 F. 2d 1330, 1334 (9th Cir. 1970); *Wood Preserving Corp. of Baltimore v. United States, supra* at 119; (8) the recipient's ability to repay the advances; *C. M. Gooch Lumber Sales Co. v. Commissioner* [Dec. 28,565], 49 T. C. 649, 657-658 (1968); (9) the recipient's ability to obtain financing from an independent lender; *Smith v. Commissioner, supra* at 180; *Georgia-Pacific Corp. v. Commissioner* [Dec. 33,118], 63 T. C. 790, 797-798 (1975); (10) provisions for interest; *Dixie Dairies Corp. v. Commissioner, supra* at 494-495; (11) subordination of the right to repayment to other debts of the recipient; *Charter Wire, Inc. v. United States* [62-2 USTC ¶ 9845], 309 F. 2d 878, 880 (7th Cir. 1962); *Litton Business Systems, Inc. v. Commissioner, supra* at 378; (12) execution of an instrument of indebtedness; *Matter of Uneco, Inc.* [76-1 USTC ¶ 9326], 532 F. 2d 1204, 1210 (8th Cir. 1976); *Post Corp. v. United States, supra* at 1304; and (13) a pattern of repeated shareholder advances, as opposed to a single outlay; *Green Bay Structural Steel, Inc. v. Commissioner* [Dec. 29,892A], 53 T. C. 451, 458 (1969).

The enumerated factors are only an aid to resolving the question of whether an advance constitutes indebtedness for Federal income tax purposes. *Dixie Dairies Corp. v. Commissioner, supra* at 494. The ultimate question

is "[w]as there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" *Litton Business Systems, Inc. v. Commissioner, supra* at 377. "In all cases, the prevailing consideration is that artiface [sic] must not be exalted over reality." *Byerlite Corp. v. Williams, supra* at 291.

On the basis of the record before us, we conclude that the advances made to Remco by petitioner were capital contributions rather than debt. *Byerlite Corp. v. Williams, supra,* cited by petitioner in support of its position that the advances were debt is distinguishable on its facts. In *Byerlite Corp. v. Williams,* the taxpayer made advances to a subsidiary corporation which operated at a substantial loss during each year of its existence. However, the Court sustained the taxpayer's characterization of the advances as loans finding that:

> Nothing could be more unreal, as we look at the whole operation, than to draw the conclusion that Byerlite's [taxpayer] advances were intended as investments in Export's capital stock. The risk of loss which was assumed by Byerlite was not assumed so that it could enjoy the chances of Export's profits; that risk was taken in carrying on its business in the procurement and sale of asphaltic materials. * * * [*Byerlite Corp. v. Williams, supra* at 293.]

In the instant case we have determined that petitioner acquired and retained the Remco stock for the purpose of investment, not as ancillary to its business of manufacturing and selling steel products. Consequently, we find that petitioner's position cannot be sustained on the basis of the analysis in *Byerlite Corp. v. Williams.*

Other factors lead us to the conclusion that the situation in *Byerlite Corp. v. Williams* is inapposite to the circumstances in the instant case. The Sixth Circuit in *Byerlite* specifically found that the transaction was not directed to the subscription of a small investment in the capital stock of the subsidiary when a large investment was required for operations and that the transaction did not supply capital investment which was needed without requiring or expecting repayment. *Byerlite Corp. v. Williams, supra* at 292. Here, we believe that Remco was seriously undercapitalized and that a substantial and committed capital base was an inherent condition and requirement of obtaining third party financing. In effect, the advances by petitioner to Remco provided an additional equity cushion for third party loans by Talcott. In addition the subsidiary in *Byerlite Corp. v. Williams* was merely a protective shell which was organized solely to remove and transport asphaltic materials which would subsequently be shipped and sold by taxpayer. *Byerlite Corp. v. Williams, supra* at 288. The subsidiary was a captive corporation, and its ability to repay the loans was controlled by the taxpayer. Unlike the situation in *Byerlite Corp. v. Williams,* Remco was a separate entity engaged in its own business enterprise, and it could only repay the advances from petitioner as well as obligations to third party lenders through its own profitable operations.

While we do not substitute our judgment for the business judgment of petitioner's officers and directors, our focus is on the true nature of the financial arrangements between petitioner and Remco. In making our determination as to the characterization of the advances made to Remco by petitioner, we have considered the factors enumerated by this Court and others. Those fac-

tors, as material to the determination in the instant case, are discussed below.

Several factors provide support for petitioner's position that the advances were bona fide indebtedness. First, both petitioner and Remco reported substantially all of the advances as loans on their accounting records. In addition both entities reflected interest attributable to these advances on their accounting records, and petitioner reported accrued but unpaid interest income on its Federal income tax returns for taxable years ending April 30, 1973, and April 30, 1974. Second, 38 percent of the Remco stock was owned by shareholders other than petitioner. These shareholders did not make proportionate advances to Remco. Third, the amounts advanced were not used for acquisition of capital assets but were used for working capital needed for Remco's day-to-day operations. Fourth, the advances were characterized as debt in resolutions of Remco's board of directors. We believe these resolutions were merely "window dressing" and note that most of the advances were ratified after the fact.

These factors, however, are not sufficient to overcome the overwhelming weight of the evidence which leads us to the conclusion that the advances were capital contributions to Remco. Initially, we must consider the fact that Remco was never a profitable entity at any time that petitioner owned the Remco shares and that it had, in fact, experienced losses in the two years immediately preceding petitioner's acquisition of the Remco stock. In addition in 1972 and early 1973 Remco had reached agreements with three of its creditors to defer payments due to these creditors.

Gurbst and Roth testified that petitioner was optimistic regarding Remco's potential for recovery. Remco's pro-

jections of financial operations for the 1973 year reflected this optimism. However, Remco's financial success for 1973 was dependent on the sales that it generated in the first six months of the year, and in particular on the sales which were generated after the Toy Fair held in February of 1973. Petitioner maintains that Remco had a positive response to the products it introduced at the Toy Fair. However, the volume of sales actually made compared to the projected amounts for the periods succeeding the Toy Fair were lower than anticipated. Although the unfavorable variances for the periods ending April 1, 1973, and May 6, 1973, were negligible compared to the total volume of sales projected, for the period ending June 3, 1973, through the period ending December 2, 1973, the volume of sales actually made was significantly smaller than projected sales.

The repayment of the advances made by petitioner was dependent on the prospective financial success of Remco. Roth testified that it was anticipated that Remco would repay the advances through availability from borrowing.[15] Remco's ability to borrow was dependent in large part on the sales that it made. It is obvious that immediate repayment would not be available from Remco's existing assets as virtually all of Remco's assets were subject to security interests. The obligations secured by the assets were in excess of the book value of the assets as of December 31, 1972.

It is clear from this record that petitioner could not have had a reasonable expectation of repayment at any

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15. Roth's contention would require us to find that capital contributions and infusion of capital are never a necessity and that working capital can always be generated from borrowed funds even though the corporation's working capital assets are totally devoured in the process leaving no room for repayment other than the financial factoring source.

time during which the advances were made. Remco had sustained losses in the two years preceding its acquisition by petitioner. There was no assurance that the changes made in Remco's management or the introduction of a new product line would make Remco a successful operation. Petitioner could reasonably evaluate Remco's prospects for success only after the first six months of 1973 during which orders were received for the Remco products. By the end of the six month period, Remco's financial condition had already deteriorated indicating that the projections had been unrealistic and Remco would not have a profitable year. The record here shows that petitioner gambled that Remco's operations would be successful. Advances made under these circumstances simply are not bona fide indebtedness.[16]

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16. It is unclear in this situation what information was available to petitioner at the time the advances were made. Roth testified that the advances were made after reviewing projections which indicated that Remco would have sufficient availability from borrowing to repay the advances. These projections were prepared or approved by Edmund Rossi, controller and subsequently general manager of Remco, and the record indicates that the projections were not available when the initial advances were made. Prior to the time the projections were available, Edmund Rossi prepared and submitted to petitioner estimates of receipts and disbursements of Remco. Edmund Rossi was also responsible for making requests for advances subject to the approval of Roth and Jack Falcon. We note that none of the witnesses at the trial of this case were able to provide specific details as to when the projections on which the advances were based were available or how Remco's cash needs were determined. In these circumstances, we believe that Edmund Rossi's testimony would be relevant to a determination of petitioner's knowledge of Remco's ability to repay the advances. When such a witness is not produced, the inference arises that any testimony given by that witness would not be favorable. *Wichita Terminal Elevator Co. v. Commissioner* [Dec. 15,171], 6 T.C. 1158, 1165 (1946), aff'd [47-1 USTC ¶ 9253] 162 F. 2d 513 (10th Cir. 1947).

Petitioner argues that the fact that Talcott continued to make loans to Remco during this period indicates that petitioner's expectation of repayment was reasonable. We cannot agree with this assertion. At least one commercial lender had declined to loan funds to petitioner for Remco's use. The Talcott loans were secured by Remco's assets which had a book value in excess of the amounts loaned by Talcott. In addition, Talcott made most of its advances to Remco on the basis of its receivables and inventory value. Talcott was specifically authorized to collect such receivables and was given a power of attorney which would enable it to negotiate any payment made to Remco. Finally, the obligations were payable on demand. Considering these factors it is clear that Talcott could quickly recover a substantial portion of the amounts advanced at any time irrespective of Remco's financial condition. Talcott did, in fact, have a reasonable expectation of repayment.

Unlike Talcott, petitioner did not have any security for its advances, nor did it have the right to collect or negotiate payments made to Remco. In effect petitioner's right to repayment was subordinated to the interests of Bankers, Talcott, and Otte. At best petitioner would share in the proceeds which remained after obligations to secured creditors were satisfied. We cannot find, under these circumstances, that the fact that a fully secured outside lender would loan substantial sums to Remco indicates that petitioner had a reasonable expectation of repayment when it made advances to Remco. In addition the resolution of Remco's board of directors which authorized receipt of advances in the amount of $175,000 from petitioner specifically stated that receipt of advances from petitioner was advantageous as the terms offered were more favorable than available through other sources of financing.

Other evidence in the record supports our conclusion that petitioner's advances to Remco were contributions to capital and not debt. Remco did not make repayments in accordance with the terms of the advances. The resolution of Remco's board of directors dated November 3, 1972, indicated that the advance in the amount of $175,000 made to Remco was to be repaid within 60 days of the date of the advance, which would require that the advance be repaid on or before January 2, 1973. This advance was not repaid. This alone is a strong indication that a true debtor-creditor relationship was not contemplated by the parties. Although petitioner maintains that advances in the amount of $587,850 were repaid, petitioner characterized this as amounts advanced for the benefit of Properties and transferred the receivable from the Remco account to the Properties account at the date when the Harrison facility was purchased by Properties. This was not a repayment, but an adjustment of accounts through bookkeeping entries in which funds were neither remitted nor applied. Apparently, the only amount which was repaid was $10,000 which was advanced on September 7, 1973, and repaid on September 10, 1973.

In addition the loan agreement executed by Talcott, petitioner, Roth Steel Products Company, Toledo, American, and Roshel required that the signatory corporations advance $1,650,000 to Remco. This indicates that Talcott desired an infusion of funds into Remco subordinate to its loans. Talcott was not concerned whether this infusion was characterized as debt or equity except to the extent that any interest or principal repayments might affect its security. We believe that Talcott as a lender engaged in financial factoring wanted a working capital cushion to be provided by petitioner and the other signatory corporations for this security. This infers a capital, and not a loan, transaction.

We also note that the loan agreement required that the advances to Remco from petitioner and the other signatory corporations be evidenced by appropriate documentation, that the resolution of petitioner's board of directors authorized its president to execute such documentation, and that the resolutions of Remco's board of directors directed its officers to execute notes to evidence receipt of the advances from petitioner. Petitioner concedes that no notes or other documentation were executed. We understand that the demands of business exigencies often require corporate executives to act with dispatch. Nevertheless, when a loan agreement requires certain documentation and the directors of a corporation authorize or direct their officers to execute such documentation, it is questionable whether a true loan was intended when no documentation is executed. In addition, here, petitioner made no attempt to receive any subordinated security interest for its advances to Remco although this was not prohibited by the loan agreement with Talcott. These actions address petitioner's intent more clearly than self serving statements that the advances were intended to be debt. These actions do not support petitioner's expressed intention.

Remco was highly leveraged. Assuming that the Harrison facility was sold, Remco's debt to equity ratio at December 31, 1972, was in excess of 300 to 1.[17] It is reasonable to infer under these circumstances that any advances made by petitioner were necessary to provide additional capital to supplement Remco's inadequate capital structure.

Finally, we note that there was a repeated pattern of shareholder advances. Petitioner made 42 advances to

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17. Petitioner has not shown that the fair market value of Remco's assets after the sale of the Harrison facility are in excess of book value.

Remco over a one year period. These advances were required to maintain Remco's operation and suggest that a contribution to capital rather than a loan was made.

It is apparent that from the inception petitioner desired to leverage an entrepreneurial risk by cosmetically transforming a venture capital investment transaction into a creditor arrangement. But the substance of the arrangement belies its poorly structured facade. Petitioner's failure to document properly its advances to Remco with executed instruments indicates its own understanding that the advances were never intended to be bona fide indebtedness.

As we have determined that petitioner's advances were contributions to capital rather than bona fide indebtedness, petitioner may not deduct its loss on the advances under section 166(a). The advances were an additional investment in Remco. As discussed *supra*, petitioner's investment in Remco was a capital asset. Any loss on these advances would be a capital loss, allowable only to the extent of capital gains. Sec. 1211(a). Petitioner reported no capital gains for its taxable year ending April 30, 1974. Consequently, we must sustain respondent's determination that no loss attributable to petitioner's advances to Remco is allowable for its taxable year ending April 30, 1974.

Finally, we must consider the issue of whether petitioner is entitled to a net operating loss deduction for the taxable years ending April 30, 1971, April 30, 1972, April 30, 1973, June 30, 1974, and June 30 1975. Having determined that respondent properly characterized petitioner's loss on its Remco stock and the advances made to Remco as capital rather than ordinary we must likewise sustain respondent's determination that petitioner is not entitled to a net operating loss for these periods.

Further, a capital loss will not affect petitioner's income for these periods. Section 1211(a) provides for an allowance of capital losses only to the extent of capital gains. Any unusued net capital loss may be carried back for three years and carried forward for five years and shall be treated as a short-term capital loss in each such year. Sec. 1212(a). The capital loss carried back or carried forward may only be utilized to the extent of capital gains. Sec. 1211(a). Here, petitioner had no capital gains for any of theses taxable years. Consequently, we must sustain respondent's determination that petitioner's taxable income for these periods is not reduced by losses attributable to petitioner's investment in Remco or its subsequent advances to Remco.

In accordance with the foregoing.

Decision will be entered for the respondent.

APPENDIX C

Order of the United States Tax Court

(Dated May 21, 1985)

Docket No. 517-78

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

ROTH STEEL TUBE COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ORDER

For the reasons appearing in the Memorandum Sur Order, served herewith, it is

ORDERED that petitioner's Motion to Vacate or Revise Decision is denied.

/s/ L. W. HAMBLEN, JR.
Judge

APPENDIX D

Memorandum Sur Order of the United States Tax Court

(Dated May 21, 1985)

Docket No. 517-78

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

ROTH STEEL TUBE COMPANY,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MEMORANDUM SUR ORDER

On March 7, 1985, petitioner filed a "Motion to Vacate or Revise Decision" under Rule 162[1] and on March 11, 1985, petitioner filed a "Supplement to Motion to Vacate or Revise Decision." In these motions petitioner requests that we vacate or revise our decision in *Roth Steel Tube Company v. Commissioner*, T.C. Memo. 1985-58.[2] For the reasons discussed below, we deny petitioner's motion.

1. All rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years at issue.

2. Petitioner also requests "that the case be reviewed by the entire Tax Court." Under sec. 7460(b) the power to designate a case for review by the Court rests with the Chief Judge. Here, the Chief Judge declined to designate this case for review by the Court.

Petitioner urges that some or all of the advances to Remco Industries, Inc. ("Remco") in the amount of $2,717,842 should be treated as debt rather than equity resulting in a net operating loss for the taxable year ended April 30, 1974. Further, petitioner maintains that it is entitled to a deduction for the amount of $50,730 which petitioner claims is attributable to accrued but unpaid interest on the loans to Remco. Finally, petitioner claims that it is entitled to net operating loss deductions for the taxable years ending April 30, 1971, April 30, 1972, April 30, 1973, June 30, 1974, and June 30 1975, resulting from the net operating loss it claims for the taxable year ending April 30, 1974. Petitioner requests that we re-examine the evidence in the record in light of applicable law. Essentially petitioner is seeking new answers to the same questions.

Initially, petitioner argues that the evidence in the record supports the conclusion that there was a reasonable expectation of repayment of the advances during some or all of the periods in which advances were made.[3] We considered the factors cited by petitioner in support of its contention in making our determination in the case. However, we found that the weight of the evidence in the record established that there was no reasonable expectation of repayment of the advances. In part our determination was based on the following factors:

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3. Petitioner notes that under some circumstances the Courts have recognized that a portion of advances made to a corporation may be bona fide debt where the facts indicate that the advances were made when there was a reasonable expectation of repayment. *Troop Water Heater Company v. Bingler,* 234 F. Supp. 642 (W.D. Pa. 1964). This situation is distinguishable from the instant case. Here, the borrower was hopelessly in debt and required an infusion of capital. There was never a reasonable expectation of repayment.

1. Remco's lack of adequate capitalization;

2. Remco's prior history of losses;

3. The fact that Remco's financial success was dependent on actual operating results of the first six months of 1973.

These operating results were only available to petitioner after a significant amount of the advances had been made; and

4. The source of projected funds for repayment to petitioner. These funds were to be supplied by a third party lender who, in turn, would only lend money based on the financial success of Remco, and, in substance, impelled petitioner to transfuse Remco with capital from petitioner. Petitioner, itself, had no security for repayment of the advances. These factors amply support the conclusion that, unlike a true creditor, petitioner was putting its capital at the risk of an unrelated business.[4] Petitioner sought a return on this investment in the form of an increase in the value of the capital stock it held in Remco, not through repayment of the advances which it made. Petitioner was willing to advance funds where the expectation of repayment was not reasonably assured in order to reap more substantial benefits as an investor. As we concluded in *Roth Steel Tube Company v. Commissioner, supra*:

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4. Petitioner argues that we gave undue weight to the lack of formal documentation. We note that this was one factor of many which we considered in making the overall determination in this case. While this factor was not critical to our determination, we find that it is one more indication that the advances were not in substance bona fida indebtedness. Of particular significance is the fact that the officers of both corporations, one with a substantial minority interest, were directed to execute notes but did nothing. Petitioner presented no reasonable explanation for their failure to act.

> It is apparent from the inception that petitioner desired to leverage an entreprenurial [sic] risk by cosmetically transforming a capital investment transaction into a creditor arrangement. But the substance of the arrangement belies its poorly structured facade.

Petitioner appears to place significant weight on the fact that projections were prepared for Remco which showed a rapid financial recovery for Remco. We believe that these projections were illusory and served only as a further masquerade to avoid classification as equity. We note that none of the witnesses at the trial of this case was able to testify as to exactly when these projections were prepared. Even had they so testified, as will be noted *infra,* there is a real credibility gap with respect to at least one of the executive officers in this case. Consequently, it is unclear as to whether the projections themselves were considered when the advances were made. Edmund Rossi, controller and subsequently general manager of Remco, one of the people who apparently could clarify the questions raised regarding the projections, was not called as a witness in this case leading to the inference that his testimony would not support petitioner's position. *Wichita Terminal Elevator Co. v. Commissioner,* 6 T.C. 1158, 1165 (1946), affd. 162 F.2d 513 (10th Cir. 1947).

Petitioner next urges that it is entitled to deduct the amount of $50,730 designated as accounts receivable. Petitioner maintains that the evidence in the record clearly indicated that this amount was attributable to interest receivable reported on petitioner's books and records. The evidence which petitioner cites is Exhibit 25, "Accounts Receivable—Remco Industries, Inc." None of the evidence submitted by the parties clearly established what this account represented. Petitioner attempted to identify the account as accrued but unpaid interest in its reply

brief. We note that petitioner has apparently ignored our evidentiary rules which clearly explain that statements in briefs are not evidence. Rule 143(b). Respondent had characterized this amount as a capital loss in his notice of deficiency and raised the issue of deductibility of the amount for the first time in his brief. In *Roth Steel Tube Company v. Commissioner, supra* at n. 3, we explained that we would not consider this issue because neither party had presented sufficient evidence to make a determination as to the deductibility of this amount. Further, it is well established that we will not consider issues which have not been properly pleaded. *Markwardt v. Commissioner,* 64 T.C. 989, 997 (1975). Had we considered this issue, petitioner would have had the burden of proving that these amounts were interest receivable which had been included in its income. *Welch v. Helvering,* 290 U.S. 111, 115 (1933); Rule 142(a). As noted *supra,* petitioner did not present sufficient evidence to meet its burden of proof, and we would have denied a deduction for this amount had we considered this issue separately.

In the alternative petitioner asserts that the Court raised a new argument not addressed by either party.[5] Apparently, the new issue petitioner believes was raised is whether the advances to Remco facilitated petitioner's business operations or those of its subsidiaries. Application of the *Corn Products* doctrine requires that "profits and losses arising from the everyday operation of a business [be] considered as ordinary income or loss rather

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5. Petitioner believes that we made an analysis of *Byerlite v. Williams,* 286 F.2d 285, 290 (6th Cir. 1960) within the context of our determination of whether petitioner's capital contributions to Remco were ordinary within the course of its business. We simply note that *Byerlite v. Williams, supra,* was not examined within this context.

than capital gain or loss." *Corn Products Refining Co. v. Commissioner, supra* at 52. Implicit within this definition is a determination of whether petitioner's day-to-day operations were benefited. We examined the testimony of Herbert Gurbst, testifying for petitioner, and found that the reasons he stated for acquisition of the capital stock of Remco did not relate to the day-to-day operations of petitioner but of petitioner's subsidiaries. Clearly, the inference arose that the *Corn Products* doctrine would not be applicable in this situation because petitioner made the expenditure to enhance its investments. Petitioner raised the issue of the applicability of the *Corn Products* doctrine which requires an analysis of whether petitioner acquired the Remco stock to facilitate its own operations. We can see no basis for considering the benefit derived by petitioner's subsidiaries as a new issue raised sua sponte by the Court.[6]

Finally, in its supplement to its motion petitioner claims that we must consider our recent opinion in *Allen v. Commissioner,* T.C. Memo. 1985-54, in making our determination in this case. The simple answer to petitioner's contention is that each determination of whether advances are debt or equity must rest on its own facts. *John Kelley Co. v. Commissioner,* 326 U.S. 521 (1946).

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6. *Prescott v. Commissioner,* T.C. Memo. 1983-761, cited by petitioner in support of its contention is inapposite to this case. In *Prescott* respondent relied on a theory which the Court found to be legally erroneous. However, the Court itself posited an alternative theory not briefed or argued by either party in support of respondent's determination. As the parties presented no evidence pertaining to this theory and the issue could not be resolved by evidence in the record, the Court returned the case for the taking of further evidence on the alternative theory. Unlike the situation in *Prescott* the issue of who received the benefit of the investment in Remco was argued by the parties. Petitioner itself introduced the evidence of which it now complains.

The facts and ultimate issues in *Allen v. Commissioner, supra,* were different than the facts and issues in this case. The primary issue in the *Allen* case was whether common shareholders of three brother/sister corporations received a contructive [sic] dividend when two of the corporations transferred amounts to the third corporation. Our determination that the transactions between the corporations constituted loans was incidental to a finding that the shareholders received no direct benefit from the transactions and consequently there was no constructive dividend. Here, our primary focus is on the characterization of the loan transaction itself.

In addition the facts of *Allen* indicate that the loan amounts could be repaid, in part, from appreciation in the value of the assets acquired by the borrower. In fact there were loan repayments made in *Allen.* The situation in this case is inapposite as the advances were made to meet the immediate needs of Remco which was in perilous financial waters, apparently had no assets which were free from security interests, and required capital infusion in order to survive. Unlike *Allen,* there were no loan repayments with the exception of $10,000.

Further, in *Allen* we found the testimony of the directors and other parties overwhelmingly supported the conclusion that bona fida [sic] debt was intended. Implicit in this finding was our determination that these witnesses were credible. In this case we note that the testimony of one of petitioner's key witnesses, Leonard Roth, was inconsistent with prior statements he had made in relationship to another matter. The prior statements were made in order to support his position in a prior administrative proceeding, a position which is not consistent with petitioner's argument in this case. Petitioner offered

no convincing explanation for this discrepancy, and the inference which we must draw is that Roth is not a credible witness.

In sum whether advances constitute debt or equity is a factual determination, and we reiterate that the facts of this case all point in the direction of equity. As the finder of fact in this case we have determined, as a matter of fact, that the advances at issue were equity. It is inescapable that Remco's debt capability was fully absorbed by third party creditors, and loans by petitioner could be nothing else but capital infusion.

Petitioner's motion, therefore, will be denied and an appropriate order will be issued.

/s/ L. W. HAMBLEN, JR.
Judge

APPENDIX E

Judgment Entry of the United States Court of Appeals For the Sixth Circuit

(Filed September 10, 1986)

Mandate of the United States Court of Appeals

(Issued October 30, 1986)

No. 85-1656

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

ROTH STEEL TUBE COMPANY,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Before: MILBURN and BOGGS, *Circuit Judges;* and DEMASCIO, *District Judge.*

JUDGMENT

ON APPEAL from a decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the transcript of record from the said Tax Court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

It is further ordered that Respondent-Appellee recover from Petitioner-Appellant the costs on appeal, as itemized below, and that execution therefor issue out of said court, if necessary.

ENTERED BY ORDER OF THE COURT
/s/ JOHN P. HEHMAN
Clerk

Issued as Mandate: October 30, 1986

A True Copy
Attest:
/s/ TOM BENNIGNUS
Deputy Clerk

APPENDIX F

Order Denying Petition for Rehearing en Banc

(Filed October 22, 1986)

No. 85-1656

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

ROTH STEEL TUBE COMPANY,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

BEFORE: MILBURN and BOGGS, *Circuit Judges* and DEMASCIO* *United States District Judge*

The Court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this Court, and no judge of this Court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT
/s/ JOHN P. HEHMAN
Clerk

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*Hon. Robert E. DeMascio sitting by designation from the Eastern District of Michigan.

Supreme Court, U.S.
FILED
MAR 23 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1200

In the Supreme Court of the United States

OCTOBER TERM, 1986

ROTH STEEL TUBE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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In the Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-1200

ROTH STEEL TUBE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner contends that the court of appeals erred in affirming the disallowance of certain claimed bad debt and loss deductions.

1. In 1972, petitioner paid $553,062 to acquire 62% of the stock of Remco Industries, Inc. (Remco), a toy manufacturer. Remco was undercapitalized and had sustained substantial losses, which had caused it to file in 1971 for protection under the Bankruptcy Act. Pet. App. A2, A20. In 1972 and 1973, petitioner made unsecured advances in the amount of $2,832,150 to Remco to be used as working capital.[1] No notes were executed with respect to the advances, which were reflected as receivables on petitioner's

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[1]In addition, $587,850 was advanced to Remco on behalf of another of petitioner's subsidiaries, Roth Properties, Inc. That amount was discharged in 1973 in connection with Remco's sale to Roth Properties of one of its operating facilities (Pet. App. A5).

books. No interest was ever charged or paid on these advances. *Id.* at A5-A6. Any repayment obligation was generally dependent on future profits; except for a $10,000 repayment made in September 1973, none of the advances were in fact repaid (*id.* at A5). Remco ceased operations in January 1974, at which point its remaining assets were turned over to a third-party creditor. On its 1974 tax return, petitioner claimed a bad debt deduction for its advances to Remco and a loss deduction for its investment in the Remco stock. *Id.* at A5-A7.[2]

2. The Commissioner determined that petitioner's advances to Remco were contributions to capital, not loans, and thus that petitioner was not entitled to any bad debt deduction for them. He also determined that the losses from petitioner's stock investment in Remco were capital in nature and therefore were deductible only to the extent of capital gains, of which petitioner had none. Accordingly, the Commissioner disallowed the deductions and determined deficiencies in petitioner's income taxes. Pet. App. A7-A8, A33.

Petitioner sought redetermination of the deficiencies in the Tax Court, which upheld the Commissioner's determination in full (Pet. App. A18-A51; 49 T.C.M. (CCH) 698). Examining several factors, the Tax Court found that "the overwhelming weight of the evidence * * * leads us to the conclusion that the advances were capital contributions to Remco" (Pet. App. A44). The court also found that petitioner had purchased the Remco stock as an investment and therefore rejected petitioner's claim that the loss sustained with respect to the stock was not capital in nature (*id.* at

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[2]This resulted in a net operating loss for which petitioner claimed carryover deductions in prior and subsequent years (Pet. App. A7).

A35-A39).[3] Subsequently, the Tax Court denied petitioner's motion to vacate or revise its decision, reaffirming its original ruling (*id.* at A53-A60). The court emphasized that "[i]t is inescapable that Remco's debt capability was fully absorbed by third party creditors, and loans by petitioner could be nothing else but capital infusion" (*id.* at A60).

The court of appeals unanimously affirmed (Pet. App. A1-A17; 800 F.2d 625). It examined 11 different factors that the courts have traditionally used in deciding whether ambiguous payments represent equity investments or loans (*id.* at A9-A15). The court found that only two of the factors supported petitioner's contention that the advances were debt, whereas the other nine factors pointed to the conclusion that the advances were capital contributions. "[C]onsidering all the factors," the court of appeals labeled as not "clearly erroneous" the Tax Court's conclusion that the advances were capital contributions rather than bona fide loans (*id.* at A15). Petitioner also argued for the first time on appeal that its loss on the securities should be an ordinary loss on the theory that the Remco shares were worthless shares of an "affiliated corporation." See Section 165(g)(3) of the Internal Revenue Code (26 U.S.C.). The court of appeals declined to consider this issue, pointing out that petitioner had failed to raise it in the Tax Court and

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[3]Petitioner had argued that its purchase of Remco stock was not for investment purposes and hence that the loss should be treated as an ordinary loss under *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955). See, *e.g.*, *Booth Newspapers, Inc.* v. *United States*, 303 F.2d 916 (Ct. Cl. 1962) (holding that common stock in certain circumstances can be regarded as a non-capital asset). But see *Arkansas Best Corp.* v. *Commissioner*, 800 F.2d 215 (8th Cir. 1986), petition for cert. pending, No. 86-751 (rejecting *Booth Newspapers*). As petitioner acknowledges (Pet. 8-9), it abandoned this argument in the court of appeals, and it has not renewed the argument in this Court (see Pet. [I]). Accordingly, the so-called "*Corn Products* doctrine" has no bearing on the instant petition, and there is no reason to hold this case pending disposition of *Arkansas Best*.

that "resolution of the issue would require further factual determination" (*id.* at A15-A16).

3. a. Petitioner contends (Pet. 12-15) that the Court should grant certiorari here to resolve a supposed conflict in the circuits about how debt/equity questions should be characterized for purposes of appellate review. The Sixth Circuit panel in this case stated that the determination whether an advance is "equity" or "debt" is "a question of fact" subject to review under "the clearly erroneous standard." Pet. App. A9; see *Smith* v. *Commissioner*, 370 F.2d 178, 180 (6th Cir. 1966). Conversely, the Fifth Circuit has stated that this "evaluation is primarily a question of law, and a district court's determination of the issue is thus subject to de novo review." *Estate of Mixon* v. *United States*, 464 F.2d 394, 402-403 (1972); see also *In re Lane*, 742 F.2d 1311, 1315 (11th Cir. 1984). Other circuits have variously characterized the determination as a "question of fact,"[4] as "essentially a question of fact,"[5] and as a "mixed question of law and fact."[6] Different panels of the same circuit—including the Sixth Circuit—have routinely described the exercise in contrasting ways.[7] And the courts

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[4]*E.g., Diamond Bros.* v. *Commissioner*, 322 F.2d 725, 730 (3d Cir. 1963); *Road Materials, Inc.* v. *Commissioner*, 407 F.2d 1121, 1123-1124 (4th Cir. 1969).

[5]*E.g., Brake & Electric Sales Corp.* v. *United States*, 287 F.2d 426, 428 (1st Cir. 1961); *Gilbert* v. *Commissioner*, 262 F.2d 512, 513-514 (2d Cir.), cert. denied, 359 U.S. 1002 (1959).

[6]*E.g., Taft* v. *Commissioner*, 314 F.2d 620, 622 (9th Cir. 1963).

[7]Compare *Scriptomatic, Inc.* v. *United States*, 555 F.2d 364, 372 n.13 (3d Cir. 1977) (question of law), with *Diamond Bros.* v. *Commissioner*, 322 F.2d at 730 (question of fact); and compare *Ragland Investment Co.* v. *Commissioner*, 435 F.2d 118, 120 (6th Cir. 1970) (question of fact), with *Austin Village, Inc.* v. *United States*, 432 F.2d 741, 744 (6th Cir. 1970) (question of law preferable); and compare *A. R. Lantz Co.* v. *United States*, 424 F.2d 1330, 1334 (9th Cir. 1970) (question of fact), with *Taft* v. *Commissioner*, 314 F.2d 620, 622 (9th Cir. 1963) (mixed question of law and fact).

have regularly responded to this apparent diversity of views by observing that the outcome would be the same regardless which view were adopted.[8]

This Court recently declined to grant certiorari to resolve this supposed conflict in the circuits. *Texas Farm Bureau* v. *United States*, 469 U.S. 1106 (1985). As we pointed out in our memorandum opposing certiorari there (84-276 U.S. Mem. 5-7),[9] the "conflict" posited by petitioner is far more apparent than real. The diverse verbal formulations adopted by the courts of appeals reflect the obvious fact that debt/equity questions involve a melange of "factual" and "legal" considerations. Once the operative facts are established, the court must analyze those facts under the relevant legal criteria—the 11-factor "laundry list" used by the court of appeals here—according each factor its proper weight and balancing one against the other to determine the proper legal characterization of the instrument involved. See, *e.g.*, *Austin Village, Inc.* v. *United States*, 432 F.2d 741, 744 (6th Cir. 1970). Under these circumstances, it is not likely to make any difference whether the court of appeals approaches its task by asking whether the trial court drew the correct inference of ultimate fact, subject to review under the "clearly erroneous" standard, or by asking whether the trial court analyzed the undisputed facts under the correct legal criteria, applying no irrelevant factors and avoiding undue emphasis on one factor to the exclusion of others. See, *e.g.*, *In re Uneco, Inc.*, 532 F.2d 1204, 1209-1210 (8th Cir. 1976); *Austin Village*, 432 F.2d at 745; *Piedmont Minerals Co.* v. *United States*, 429 F.2d 560, 562 & n.4 (4th Cir. 1970); *A. R. Lantz Co.* v. *United States*, 424 F.2d 1330, 1333-1334 (9th

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[8]See, *e.g.*, *Austin Village*, 432 F.2d at 745; *Lundgren* v. *Commissioner*, 376 F.2d 623, 625-626 (9th Cir. 1967).

[9]We are furnishing petitioner's counsel with a copy of that memorandum.

Cir. 1970); *Brake & Electric Sales Corp.*, 287 F.2d 426, 428 (1st Cir. 1961). In short, whether the question should be styled one of fact or of law is a matter of little more than philosophical interest.

b. In any event, even if there were thought to be a genuine "conflict in the circuits" on this issue, the instant case would not present an opportunity for the Court to resolve it. Petitioner's advances to Remco would plainly be characterized as capital contributions by any circuit, under any standard of review. Thus, resolution of the supposed conflict would have no bearing on the outcome of this case.

The court of appeals analyzed petitioner's advances to Remco by reference to 11 factors, including the presence or absence of a fixed maturity date; the presence or absence of a fixed rate of interest; the source of repayments, if any; the adequacy of capitalization; the security for the advances; the corporation's ability to obtain third-party loans; the presence or absence of subordination; the uses to which the advances were applied; and the presence or absence of a sinking fund to provide repayments. These are the factors that have commonly been recognized as relevant by the courts of appeals.[10] The Sixth Circuit here found (Pet. App. A12-A15) that virtually every relevant factor supported the

[10]This Court recently denied certiorari in *Piggy Bank Stations, Inc.* v. *Commissioner*, 755 F.2d 450, 454 (5th Cir. 1985), cert. denied, No. 85-22 (Oct. 7, 1985), despite a taxpayer's protestations that the courts have applied these factors inconsistently. In actuality, the courts uniformly cite the same factors, stressing that the factors are not of equal weight and that no one factor controls. See *Casco Bank & Trust Co.* v. *United States*, 544 F.2d 528, 532 (1st Cir. 1976), cert. denied, 430 U.S. 907 (1977); *Gilbert* v. *Commissioner*, 248 F.2d 399 (2d Cir. 1957), on remand, 262 F.2d 512, 514, cert. denied, 359 U.S. 1002 (1959); *Fin Hay Realty Co.* v. *United States*, 398 F.2d 694, 696 (3d Cir. 1968); *Jewell Ridge Coal Corp.* v. *Commissioner*, 318 F.2d 695, 699 (4th Cir. 1963); *In re Uneco, Inc.*, 532 F.2d 1204, 1208 (8th Cir. 1976); *Bauer* v. *Commissioner*, 748 F.2d 1365, 1368 (9th Cir. 1984); *Hayutin* v. *Commissioner*, 508 F.2d 462, 473 (10th Cir. 1974); *In re Lane*, 742 F.2d at 1314-1315; *Post Corp.* v. *United States*, 640 F.2d 1296, 1307 (Ct. Cl. 1981).

determination that petitioner's advances were capital contributions.

In particular, the court noted that Remco was seriously undercapitalized, with a debt-equity ratio in excess of 300 to 1. This factor, the court said, was "strong evidence" that the advances were capital contributions (Pet. App. A11-A12). The court also explained that there were no instruments of indebtedness, no fixed rate of interest, and no schedule of payments, all of which belied the argument that these advances were loans (*id.* at A12-A13). The court noted that petitioner's advances were unsecured and that there was no sinking fund to ensure repayment; rather, repayment could come only out of Remco's earnings (*id.* at A12-A14). "If the expectation of repayment depends solely on the success of the borrower's business, the transaction has the appearance of a capital contribution" (*id.* at A12). And the court pointed to the fact that Remco generally was unable to obtain outside financing, concluding that "[t]he fact that no reasonable creditor would have acted in the same manner as [petitioner] is strong evidence that the advances were capital contributions" (*id.* at A14).

Against this overwhelming evidence that petitioner's advances represented an equity investment, the court noted that only two factors—the non-pro-rata nature of the advances, occasioned by the fact that petitioner held only 62% of Remco's stock, and the fact that the advances were used for working capital rather than the purchase of long-term assets—could be read to support petitioner's desired characterization of the advances as loans. But it is not necessary to give any particular deference to the Tax Court's determination to conclude that it was correct in holding that these factors did not outweigh the massive evidence pointing in the opposite direction. See Pet. App. A44-A50. Accordingly, it is manifest that this case presents

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no occasion to decide whether the Tax Court's determination should be reviewed under the "clearly erroneous" standard or under a de novo standard of review.[11]

4. Petitioner also challenges (Pet. 16-17) the court of appeals' refusal to consider its contention that it was entitled to an ordinary loss deduction under Section 165(g)(3), a refusal based on the fact that petitioner had failed to advance this argument in the Tax Court. It is well established that the courts of appeals have discretion to decline to consider an argument not raised in the trial court. Indeed, particularly where, as here, the new argument would require additional factual inquiry (see Pet. 17 n.6; Pet. App. A16), the appellate court ordinarily should not consider such an argument in the absence of special circumstances not present here. See generally *Singleton* v. *Wulff*, 428 U.S. 106, 121 (1976). Because consideration of issues raised for the first time on appeal is generally committed to

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[11]Petitioner does not specifically contend that the courts below erred in finding the advances to be contributions to capital, but it does suggest in a footnote in the statement (Pet. 8 n.1) that the Fifth Circuit would view *either* of the last two factors discussed in the text as dispositive that the advances were loans, regardless of the evidence pointing the other way. This suggestion is plainly mistaken. The Fifth Circuit, like other circuits, has always taken the view that no one factor controls. See *Piggy Bank Stations, Inc.* v. *Commissioner*, 755 F.2d at 454. Indeed, it is not apparent that the Fifth Circuit would accord much weight at all to the non-pro-rata character of petitioner's advances, given the context of this case. While a substantial advance from a 15% shareholder may look more like a loan than a contribution to capital (see *Estate of Mixon* v. *United States*, 464 F.2d at 409), it is not uncommon for a majority stockholder like petitioner to make efforts, in which the minority shareholders are unwilling to join, to infuse capital into a failing corporation, thereby yielding a non-pro-rata contribution to capital. And when a corporation is so thinly capitalized that it lacks funds to pay its operating expenses, the fact that advances are used to pay those expenses is hardly inconsistent with characterization of the advances as contributions to capital.

the court's discretion (see, *e.g., ibid.; United States* v. *Manzella*, 782 F.2d 533, 546 (5th Cir. 1986), cert. denied, No. 85-6740 (May 19, 1986)), petitioner's citation of instances where a court of appeals has elected to consider such an issue (see Pet. 16-17) plainly does not establish a conflict in the circuits. Contrary to petitioner's assertion, the Fourth and Fifth Circuits adhere to the general rule that an appellate court ordinarily will not review an argument not raised below. See, *e.g., Furka* v. *Great Lakes Dredge & Dock Co.*, 755 F.2d 1085, 1089 (4th Cir. 1985); *Moore* v. *Commissioner*, 722 F.2d 193, 196 (5th Cir. 1984).[12]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

MARCH 1987

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[12]We note incidentally that petitioner's underlying contention is totally without foundation. Section 165(g)(3) of the Code establishes as one prerequisite to its invocation that the taxpayer own at least 80% of the voting power of the "affiliated corportation." Petitioner owned only 62% of Remco's stock.